HOW TO FINANCE A BUSINESS

WHERE AND HOW TO RAISE MONEY AND CREDIT—HOW TO USE THE BANK—HOW TO BUDGET AHEAD, HANDLE DAY-TO-DAY FINANCIAL NEEDS, GIVE CREDIT, COLLECT ACCOUNTS —PLANNING TO MAKE ENDS MEET —HOW TO HANDLE RESERVES AND INVEST SURPLUS

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CHAPTER I

Finance as the Business Keystone

IN any business, the man who holds the purse-strings holds control.

Every form of business activity focuses itself eventually on the payment of money, and is subject to the review of the man who signs for the payment of that money.

There is an old-established London firm doing a world-wide distributing trade, and having an annual turnover of a million to a million and a half pounds sterling. The head of this firm is getting on in years, and considers himself of an age entitled to take things easily. A little while ago he was asked what portions of his business he supervised personally. His answer was this:

"I do very little personally. The chief men of my organisation are just as capable as myself of negotiating good purchasing contracts and good selling contracts, of devising plans of sales development, advertising and office system. It is only in exceptional cases that these problems are brought up to myself. But I do two definite things in the business: I sign every cheque and draft, and I sign every letter and document which goes to a bank. The first ensures my control of the cash, and the second ensures my control of the credit."

The above is very shrewd. It places this proprietor in direct and detailed control of the finances of his busi-

ness. It means that every item of expense is subject to his scrutiny, and if any payment seems to him unusual or leading in an unwise direction, he can investigate and correct.

Further, the signing of every letter or document to a bank means this: credit is the life-blood of the business. The trade of one million to a million and a half pounds per annum is conducted on a working capital very tiny in proportion to turnover. The large purchases of goods are financed almost in their entirety by various English and foreign banks, who lend up to 100 per cent. of the value of the material while it is in process of transit and re-sale. Any operation affecting loans or credit is therefore vitally important, and he governs it himself by the process of approving and signing any documents going to a bank.

Though most big business men do not confine themselves so narrowly, but spread their activities over many departments of their organisation, yet always they regard this handling of finance as the main pillar of their business, and the principles on which they operate govern the success of the concern.

In a big New York office there is a man in control of a chain of a thousand retail stores. If you go into his office at ten o'clock in the morning, you are likely to find his glass-topped desk free of every paper but one—a daily summary of the main figures of his business—*a bird's-eye view of the money end.* That daily document determines his trend of thought for the business as a whole. It tells him in which direction he needs to concentrate his personal energies.

Finance determines policies.

It determines policies in *any* business—large or small. The concern with a working capital of only £500 can

take pointers from the organisation which has a million. In most cases the large organisation does not "play about" with its capital; it uses it with concentrated thought and a very keen eye to future probabilities. This book is intended for the medium-size and smaller business concerns. Where examples are taken from the actual working of very large organisations, it is because the principles of finance used by them can be usefully adapted and applied to firms with lesser capital.

CHAPTER II

Raising Capital for a New Business

ALMOST every man who has built up his own successful business looks back with pride to the struggle of the first start.

Some merchants have begun with an office boy as their complete staff—and a working capital of forty or fifty pounds. Some builders and contractors have begun on a similarly tiny amount of money.

But usually, in retail and in manufacturing, £500 to £1,000 is the least that is necessary to make a *real start*. One cannot always "learn to walk before one learns to run." As with mastering a bicycle, one has to ride quickly before one acquires the art of riding slowly. Or, in other words, certain types of businesses *cannot* be started very small or very slowly—they have to be taken at a quicker pace, which means a fair amount of working capital right from the start.

And the difficult problem of many a young business man is to raise that sum of money.

The sources of capital are:

1. The man's own personal property; his stocks and shares; his insurance policy; and his cash savings.
2. His friends.
3. Strangers with capital, to be taken into partnership.
4. Banks.

Let us take the latter source first. If one is thinking of approaching a bank for capital with which to start a new business, it is well to know the general attitude which the bank manager will take towards your proposition. One has to go to the bank with a proposition which is in line with its principles of operation.

Now banks are essentially trustees for their depositors. They have no money to lend except that furnished by their depositors. And they are expected to lend it cautiously and conservatively—on assets which are already in existence, and which can be turned into cash, if necessary within a short period.

A bank cannot help to raise capital for a new business as such. The banker expects you to have sufficient capital of your own—or property and securities on which money can be lent—so as to start your business yourself as a going concern. The bank is always prepared to consider the lending of money on land and property, when valued by its own appraisers; or on stocks and shares which are considered by the headquarters of the bank to be sound security; and particularly on insurance policies. But the bank will not give you original capital in order to set your business going.

Therefore it is useless to approach the bank manager with the proposition that he should advance money for conversion into buildings and machinery and office fixtures, and that a mortgage should then be given to the bank on these forms of property and machinery. The assets must first be in existence before the bank will lend money on them.* In approaching a bank for

* A bank can perform many highly useful services in many directions for the business man. Seldom is the bank's full service made use of, especially in the small business. These services will be found in detail in Chapter IV entitled "What your Bank can do for you."

a loan, one must go there with documents which represent tangible and existing assets. And further, these assets must not be already mortgaged in any form. A bank does not care to lend on a second mortgage. It must always have a prior claim on securities.

Nor is it sufficient to offer tangible securities in order to be *certain of a loan for a long period.* It must be remembered that a bank is being asked for loans every day in the week. It can pick and choose amongst its borrowers. When funds are plentiful, it may perhaps lend to every one of them. But when money becomes tight, it is obliged to call in certain of its loans—indeed, it has the right to call in any loan at any moment. And at such times it has to discriminate between those whom it considers "good customers" and the others.

A "good customer" is primarily a man in whose honesty and integrity and general ability the bank believes. The volume of money he passes through the bank is naturally of importance, but first of all the bank want to feel that it is dealing with a man on whom it can rely for integrity. Therefore, one should either have built up for some years beforehand a feeling of confidence in one's integrity and one's general business capacity; or, if it is a question of opening a new account with a bank, then it is vitally important to remember that an attitude of frankness and straightforwardness will be expected by the bank manager, and that he will be looking not merely at the interest on the loan he is asked to make, but also at the probabilities of your being a "good customer" in future years.

Any questions asked by a bank manager about one's business affairs or one's personal affairs should be answered frankly and fully. He is entitled to ask these

questions. He is entitled to satisfy himself as to your integrity and your general business capacity. If any doubt is created by hesitancy or evasions in answering questions, that immediately places you in a bad position in his mind, and even if he recommends the loan to his loan committee, he may do so with the idea of not allowing that loan to run on indefinitely.

We all know that British bankers are extremely cautious and conservative. This is a source of immense strength to our general financial structure. And if a bank manager deals with your proposal in a cautious and conservative spirit, it must be remembered that this is part of the general principles on which his bank operates—and it is not to be railed at.

Raising Money from Friends

The second method of raising money—from friends—is sometimes very difficult, because every man starting a new business is sure to be over-sanguine of its success—or at least his friends are inclined to think so, and if they are business men themselves, they will inevitably discount his forecasts.

Two men, both going on for forty, had been working for many years as employees of an addressing agency. One was an inside man in control of staff, and the other was an outside traveller. They quarrelled with their employer and left. Then they entered into partnership with a lady, who had an established business; put the bulk of their money into her business of which she kept a voting control; after six months or so they found it was impossible to work with her, and they threw it up.

Their idea was to start an addressing agency of their own, where they would be "masters in their own house," but their capital and borrowing capacity was

now reduced to about £200 apiece. Each had a family to support. Their relations and immediate friends did not feel inclined to entrust them with money. The prospect looked hopeless. They felt "down and out."

In this desperate situation they applied to a business friend for advice. His answer was this: "Prepare a rock-bottom statement of figures of expenses and probable turnover for the first year. Include in this an order for the handling of a couple of hundred thousand circulars which I can influence in your direction, so as to start you on a 'going basis.' Let me go over this statement and revise it until I feel I can recommend it as a sound business proposition. I will then call together a small meeting of business men who know you and know myself, and I will endeavour to get them to put up the capital you need."

The meeting took place. The friend put up the proposition to the meeting to this effect: "We all know Smith and Brown. They are good fellows. They are absolutely on the square. They know the addressing agency business through and through. All they need to make a big success is £1,000 working capital. They can put up £200 apiece in cash. They want £600 more. Here are the estimates of expenses and turnover. You will note that they get a big preliminary order from my firm. This will keep Smith and his addressing staff busy for a couple of months while Brown is securing orders from other firms. It will be a going concern from the start. Smith and Brown both agree to draw only a very small salary out of the business. It looks to me like a fine investment. That £600 should be in the shape of a loan forming a first charge on the assets of the business, and entitled to so much per cent. of the net profits."

The money was subscribed by the meeting. And the two partners built up the business within a couple of years into a real success.

Now the point of the above incident is that the man who is going to start a new business is not usually the best salesman for securing the capital. His estimates of expenses are sure to be regarded as too low, and his forecast of profits as far too high. Any experienced business man will trim them both, and then add 10 per cent. to the expenses for "unknown contingencies," and perhaps another 10 per cent. for "the factor of competition"—*i.e.*, the probable inefficiency of the new business during the first couple of years as compared with the efficiency of old-established competitors who have got their businesses into smooth running order.

The aspirant will be fortunate if he can secure some neutral friend, who has no money at stake either way, who is not financially interested in the promotion, to present the proposition to a little circle who have spare capital to invest. The assurances of a neutral are much more likely to carry weight than the forecast of the man who is so directly and violently interested in securing working capital.

Taking in a Partner with Capital

The Times Business Opportunities Column and the *Daily Telegraph* Partnerships and Financial Column are always full of people on the one hand wanting money, and on the other hand seeking investments for their capital. Some of the big provincial dailies are also excellent advertising media for these purposes. And there are partnership agencies in every large city which specialise in bringing people together.

But the choosing of a stranger as a working partner

is terribly chancy! The stories one hears from men who have at one time or another tied themselves to the wrong kind of partner! He may be a little-minded man who cannot rise above the counting of pennies and the carrying out of routine details; or he may be an "enthusiast" with his head in the clouds and no contact with earth; or he may have any one of a score of other vital business defects.

The risks are very heavy. A working partner cannot be dismissed like an employee. He is practically a fixture. It is usually wiser, where possible, to take in a "sleeping partner," who is agreeable to provide money without demanding a working post. But it is better to have money put up by several people in small sums than by one man in a large sum.

The question also arises as to whether one should form an unlimited liability partnership or a company with limited liability. The latter is easy and sounds "safer." And it is. But other people also know it! Wholesale and supply houses are more reluctant to give credit to a new "company" with a small capital than to an individual or a partnership. Either of the latter means a personal responsibility for debts incurred. The directors of a company are *not* personally responsible. Therefore a young company is a bad credit risk for a wholesale house. Indeed a bank usually will not enter into commitments with a company except when endorsed by a *personal guarantee* of the directors jointly and severally.

The proper time to form a small business into a company is when it is well established and showing a good net profit, and needs additional capital for new developments. The methods of raising extra capital at such a time will be discussed in later chapters.

CHAPTER III

Raising Credit for a New Business

THE manager who is responsible for determining on the extensions of credit of a wholesale or supply house is naturally inclined to be suspicious. He is usually an oldish man who has passed a good part of his life in the book-keeping department, and therefore has an abundant experience of customers who will not pay promptly, who will evade their obligations, who will fall into insolvency and therefore cause losses to the house; he has seen the detailed records of customers who start off with a loud flourish and afterwards do badly, as well as customers who start off in a tiny way and develop gradually into big and sound accounts. Therefore he is naturally inclined to scepticism, and is not to be impressed by glowing talk on the part of the proprietor of a new firm, just starting business and asking for credit.

The credit manager is of course governed in his decisions by the general conditions of trade. In times of general confidence and business prosperity his attitude is naturally very different from that in times of general trade depression.

Let us consider the latter first. At such a time the credit manager is favourably inclined towards granting credit to the young business rather than to the business of a few years' standing. The reason for this was explained by a credit manager in 1923 to this effect:

"Practically every existing business in the manufacturing or the retail had suffered severely through the slump of 1921 and 1922. It had to take heavy losses

on raw material or goods already in stock. Some firms had absolutely cut their losses and were starting with a clean sheet. But many others had still to recognise fully the losses they had made through depreciation of raw material and stock. They were not down to bed-rock. Also, we were not sure that prices of staples might not come down yet further before the turn-of-the-tide really set in.

"So we had to be particularly careful in those days in extending credits to established businesses, even though they might have paid their debts properly in the past. Also, in general, we were allowing in 1922 only half the credit which we allowed in 1919. The prices of raw materials and goods, we reckoned, had fallen to about half; and, therefore, the manufacturer or retailer ought to be able to work on half the amount of credit needed in 1919.

"When a *new man* comes to me for credit in times of depressed trade, I am, as I said before, favourably inclined towards him. I know he is not burdened with stock bought at higher prices than to-day's. He is starting somewhere near the bottom of the trough of depression and low prices."

In Times of Business Confidence.

The attitude of the credit manager then becomes less frozen-hearted. He is fully alive to the prospects of increasing trade, and he wants to secure as much of this for his house as can be done without taking undue risks. He knows that a beginner of the right calibre can find a profitable niche in business as well as the established firms, and that he may produce new sales apart from splitting the consumer's buyings with existing competitors.

"The type of beginner I like," said a credit manager,

"is the young fellow who has worked steadily for years in one line of business as an employee, and has managed to save up £500 or so, and is perhaps able to raise another £500 or so from his relatives and friends.

"I want to satisfy myself in conversation with him that he is starting his business in a good location, if retail, or in a likely line of manufacturing or contracting. I want him to show me that he understands his business, and that he has a reasonable capital of his own to start with, and that he is not trying to start a new concern on a ten-pound note by asking for credit in every direction.

"Our travellers are allowed to open an account on their own responsibility up to £10 per month. If the line of credit required is beyond that, I want to see the man and talk to him.

"We are not anxious in general to secure 'big' customers. We would sooner have ten customers with a credit line of £100 a month each than one customer with a credit line of £1,000. We feel our risks are lessened if they are widely distributed. We do a lot of trade in supplying builders and contractors, and are always ready to support a new man who looks to us to have the makings of success in him. But we do not want 'big talk' from him.

"Some people ask for credit as though it were something entirely different from money. This is a wrong attitude. Credit means money payable at some future date. Goods mean money. We have to pay for the goods we supply to our customers. When we extend credit we are lending money—really lending the money of the manufacturers who supply us with goods. If a large number of our customers were to fail to pay up for what we supply them, we should have to fail to pay what we owe to the manufacturers.

"Therefore, in extending credit I am really lending other people's money to my customers—in much the same way as a bank lends its depositors' money to its borrowers; and I feel my responsibility in somewhat the same way as the bank manager feels his."

Approaching the Credit Manager

In approaching a wholesale house for credit, the owner of a new business should be careful to carry with him a conservative statement of his resources and his trade estimates to give to the credit manager if asked to do so.

There is always a feeling of "stability" about written figures. Not necessarily "reliability." The figures of resources may be untrue, and the estimate of trade prospects exaggerated. But at least they are down on paper, on record, to be placed in the credit manager's file; and if at any future date occasion arises to question the figures, they are instantly available to him.

Verbal statements, on the other hand, are not subject to easy reference at a future date. They are not stable. They are subject to the memories of the speaker and the hearer.

The figures given should of course be such that the borrower himself feels perfect confidence in them—figures on which he can reckon he is *entitled* to borrow credit. If a man betrays lack of confidence in himself and lack of that feeling of *entitledness*, if he presses for credit too eagerly and is ready to give all sorts of guarantees for due payment, he is liable to be turned down.

Another London credit manager put the reason for this in the following way:

"If I feel doubtful about a man, I ask for a mort-

gage on some property of his. Probably he has it mortgaged already. I then ask that he have the debt guaranteed by the holders of the mortgage. If he agrees to that, I feel still more suspicious about him. A man who is ready to agree to that kind of thing is likely to be so 'shaky' that he has already been turned down by other wholesale houses. I don't want 'shaky' customers. I would sooner they buy from my competitors!"

The figures to be set down on paper would of course vary according to the nature of the business, but would certainly include the following:

Working Capital.

Preliminary Expenses, including fixtures and fittings, furniture, fascia, etc.

Estimate of *Running Expenses* for one year, itemised, and reckoned in two ways—as so much money, and as a percentage of the total expense:

	£ s. d.	Per cent. of total.
Rent, Rates and Taxes	...	
Staff Salaries and Wages and Insurance	...	
Printing and Advertising ...	...	
Postages	...	
Packing and Dispatch	...	
Lighting and Heating	...	
Telephone	...	
Fire Insurance	...	
Auditor's Fee	...	
Travelling Expenses	...	
Bad Debts	...	
Wastage (as in the drapery trade, through overcutting of material)	...	
Mortgage Interest (if any) ...	...	
Bank Charges	...	
Miscellaneous Sundries	...	
Unknown Contingencies ...	...	10 per cent
Total Expenses £	...	100 per cent.

Estimate of Revenue for one year, itemised roughly into Departments:

Dept. 1:	Sales of so many	... £		
	Less Cost of Stock	... £		
Dept. 2:	Sales of so many	... £		
	Less Cost of Stock	... £		
Dept. 3:	Sales of so many	... £		
	Less Cost of Stock	... £		
			Total Revenue £	

Percentage of Profit, reckoned on Selling Price:

Dept. 1	...	...	...	per cent.
Dept. 2	...	...	...	per cent.
Dept. 3	...	...	...	per cent.

In the case of a manufacturing business, practically all the above headings would hold good, except that raw material would take the place of stock, and that certain items of factory maintenance would have to be added. Also salaries and wages would be treated as separate items.

With the above detailed figures before him, a credit manager of experience would be able to decide if the totals were reasonable estimates, and if the percentages of the various expense items were in accordance with general practice. He would also look closely at the itemisation of revenue, and probably inject some advice from his own experience of the sales effected by many similar businesses.

CHAPTER IV

What your Bank can do for you

THE complete range of services which a bank can offer to the business man are not always completely known and appreciated. It may therefore be useful to summarise them, and point out some of the services which are not generally utilised to the fullest:

1 and 2. Without touching on the obvious conveniences and advantages of this, it may be mentioned that a bank account performs for a business some of the functions of a book-keeping department.

When your clerk hands the daily money into your bank he presents duplicated deposit slips with it. One copy is for the bank, the other copy is for your firm. The receiving teller for the bank ticks off the various items of cash, postal orders, cheques, etc.; verifies the total; initials it; and hands it back to your clerk.

The receiving teller is so expert at this work, and his figures are re-checked by the bank in so many ways, that his O.K. can be taken as *accurate*, and therefore as offering a definite figure of your daily business on which *you can rely*.

3. The advantage of payment by cheque, rather than by any other form of payment, is not always realised. The point is that it gives you about three days' extra use of your money: that is to say, while the cheque is in the post, while it is being paid into the other man's bank, while it is being cleared at the Bankers' Clearing House, and until it is actually entered

against your account in your bank—about three days in all.

The point may seem a small one, but in the conduct of a large organisation its figure is something quite tangible—three days' use of a million pounds at (say) 5 per cent. interest would mean a sum of £411. If your *annual outlay is £50,000, payment by cheque means* £20 in your pocket.

And, of course, "a cheque is its own receipt." If you mark on the cheque (in brackets) the purpose for which it is drawn, you need not trouble about whether a receipt is sent to you or not. A cheque "cleared" and paid is evidence in a court of law.

4. A bank is always ready to put your surplus money into a deposit account carrying interest. This is sometimes an advantageous way of making temporary surplus money work for you. For short periods it may give a better return than Government Savings Certificates.

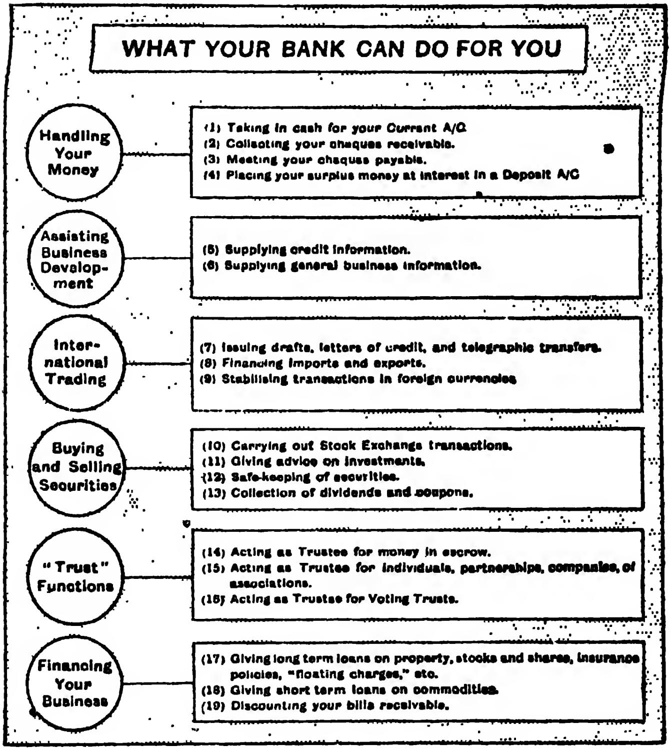
5. One should certainly look upon one's banker as a source of credit information for one's trading, and particularly if the trading extends beyond the United Kingdom.

The banker is ready to assist with this information so far as it lies in his power, because he naturally does not want his customer to incur "bad risks." He is directly interested in maintaining your solvency. He is ready to warn you against undesirable commitments; and such a warning from a bank may sometimes be of the utmost value.

The bank's information on the credit standing of your potential customers can be taken in conjunction with that obtained through a mercantile credit agency. The two together give highly useful guidance.

6. One should also look to one's banker as a source of *general* business information.

The branch manager of a bank has two sources of information about business conditions. In the first place, locally, because he is in close touch with the financial conditions of many firms in your own locality,



and, perhaps, in your own line of trading. And, secondly, through his headquarters he is in touch with trading conditions all over the United Kingdom and also throughout the civilised world.

Bankers can therefore "feel the pulse of trade" with

far greater certainty than the average business man. They know when "things are getting worse," or when "things are getting better," considerably in advance of the business man who is familiar only with conditions in his own particular line.

Therefore, a chat with one's bank manager from time to time regarding future trading prospects may be of very considerable value. It is a service on the part of a bank of which the fullest advantage should be taken.

International Trading

7 and 8. As mentioned above, a firm about to do business abroad will find it an advantage to have an account with one or more foreign banks as well as with a British bank.

The exact process of paying for goods bought abroad, or receiving payment for goods sold abroad, so as to safeguard the rights of both parties to the transaction, may take different forms. Consult your banker. He knows. He will advise you as to the best form of procedure in your individual case.

9. If your trading is in terms of foreign currency liable to sudden fluctuations in the rate of exchange, a bank can help to *protect you* by buying or selling foreign currency "forward" in an amount sufficient to cover your invoice. Your banker carries through thousands of these transactions; will show you exactly how it is done; and can warn you against *pitfalls*.

For instance, the following has happened many times. An English merchant wishes to buy some goods from Germany. The German manufacturer quotes him in marks. The Englishman is going to sell to his own customers in sterling. Therefore he wants to base the whole transaction on sterling.

If, between the time of ordering the goods and the time of paying for them, marks were to *rise* in value, he would possibly lose far more than his sales profit.

So he asks his bank to "buy marks forward" for him to the amount of the German invoice, at to-day's rate of exchange. In effect, the bank keeps those marks for him until the time comes for payment. The merchant "knows where he is" in that respect.

But suppose the mark *falls* violently in value. The German manufacturer may then repudiate the contract —refuse to deliver. This has occurred in many cases. The English merchant is "landed" with a bunch of marks on which he has to take a serious loss.

Your banker, who has had experience of such cases, will point out to you that it is *not* sufficient protection to "buy marks forward." He will tell you that you have to be very sure of the *credit standing and general integrity* of the German manufacturer. He will probably be able to secure this vital information for you before you commit yourself.

Take the instance of *another pitfall* which happened recently. In this case the German manufacturer did not break contract. He shipped the goods, payment as "cash London against shipping documents."

The English merchant had sold them forward to a London firm. When the goods arrived at the London docks, he presented the shipping documents to his customers to be paid for in cash. The firm gave a *cheque* in payment.

Depositing the cheque with his bank, and telling them to remit the agreed price in marks to the German manufacturer, he at once "released" the goods from the docks, and felt the transaction was over, with a nice little profit in his pocket.

But far from it! The next morning he learnt that his customers had refused to accept delivery at their warehouse, on the excuse that the goods were not up to sample. And to "bang and bolt the door," they *stopped the cheque.*

It must be remembered that two days or so are needed to "clear" a cheque. It is not actually cash until it *has* been cleared.

And the point of this incident—highly expensive for the merchant—is that "cash against documents" should be demanded in the form of bank notes, or treasury notes, or a "*marked*" cheque—*i.e.*, a cheque which cannot be stopped.

To avoid such pitfalls in foreign trading, consult your banker.

Buying and Selling Securities.

10 and 11. A bank is always glad to carry through Stock Exchange transactions for you, because it receives half-commission from the stockbroker.

There is no advantage to you in the matter of *price*, but there is in the direction of *value*. Your bank manager may sometimes be able to offer a word of warning in regard to doubtful shares, because his headquarters keep a watch on such securities. They do so in order to warn their branches against lending money on the collateral of those shares. Therefore the branch manager is able to pass on this warning to yourself.

Investing successfully is as difficult as any kind of trading. Remember that the headquarters of banks are big investors themselves, with sources of knowledge unavailable to the average business man, and in close touch with "the trend of things." Therefore they are in a position to *advise*.

It is always a useful test of the intrinsic value of a

share to ask your banker how much he is prepared to loan on it. And if he tells you that his headquarters have instructed him to reject it as collateral, then you definitely know you are taking a gamble in buying such shares, and you go into the gamble with "eyes wide open."

A bank can also save a risk on your part in the selling of shares. One need not post securities to a stockbroker before receiving the cash for them. The bank will take your shares, and send them by bank messenger to its city office, and hand them to the stockbroker only against cheque for the amount due to you—or, if you prefer it, actual cash.

And *vice versa*, in buying shares, one can instruct the bank to pay the stockbroker for them at city headquarters only against delivery of the actual scrip.

12 and 13. In the case of coupons cut from "Bearer Bonds," one incurs another kind of risk in sending them through the post. They may fall into the hands of the wrong person. They are cashable by *anybody*. Any clerk could present and cash them.

It is safer to let a bank collect on coupons.

And for the safe keeping of securities, where better than in the vaults of a bank, protected by the most up-to-date safeguards against burglary and fire?

Trust Functions.

14. Another useful function of a bank is to act as temporary trustee for money to be paid over on completion of a contract.

It not infrequently happens that two business men want to make a deal which depends on such-and-such conditions. One man wants to be quite sure that he will get his money if he fulfils his contract, and the

other man wants to be certain that the contract will be fulfilled before he parts with his money.

In such cases the money can be placed "in escrow" with a bank, to be released to the seller on the completion of certain written conditions; or to be returned to the buyer if these conditions have not been fulfilled within a definite period.

15. The bank can also act as permanent trustee in a partnership or business association, and in that way provide a useful "neutral" to see that all parties get their full rights.

16. Further, a bank can serve as trustee for a "voting trust"—that is to say, where a block of shares belongs to one party, and the *voting rights* in those shares are given over to another party for a definite period. This is sometimes a useful and acceptable form of offer in a financial negotiation where one party requires to have a large "say" in the policy of the company, and therefore must have a large block of voting power, even if he does not definitely own the shares which give the right to those votes.

The other three functions of a bank—(17) giving long-term loans, (18) giving short-term loans on commodities, (19) discounting your bills receivable—will be treated in the next chapter.

CHAPTER V

Getting Ordinary Accommodation from a Bank

SO far we have dealt with the functions of a bank other than that of lending. No. 17 on our chart—the subject of obtaining long-term loans from a bank—has been touched on in Chapter II. It will be dealt with at considerable length in Chapter VIII. This relates to exceptional loans.

18 and 19. The "ordinary" loans by a bank—*i.e.*, money advanced *for short periods* in the normal course of one's trading—are the discounting of your bills receivable, and loans on your commodities in course of transit or in storage in a warehouse.

The attitude of a bank towards the granting of all classes of loans *depends most of all on your personal credit and standing with the bank.*

For a short-term loan on commodities, it is usual for a bank to lend 80 per cent. to 85 per cent. of the cost price. But this difference of 15 per cent. or 20 per cent. does not really cover the bank's risk. During a period of sudden slump, commodities may tumble in a few months to 50 per cent. or less of their cost price. This has happened in the past with commodities such as wool, leather, sugar, tobacco-leaf, silk, copper, meat, and so on. Every banker knows that a heavy fall in price is not outside the range of possibility with any commodity whatsoever.

A similar risk is taken with the discounting of your

bills receivable. The firm who owes the money to you may fail to pay, or may "protest" the bill. The banker has to look to that possibility. His safeguard comes down in reality to your own credit standing—whether you will be able and willing to meet the debt under the pressure of sudden adverse circumstances.

And, therefore, when he lends, he does not look merely at the value of the *material* security. He looks to the credit and general standing of the borrower—the 'moral risk.'

How Your "Credit Standing" Counts

It is vitally important, therefore, for the future financing of your business that you establish in the mind of your banker a feeling that he can *trust you* in the event of "things going wrong."

Some British firms are able to borrow as much as 100 per cent. on commodities. An instance of this was mentioned in the introductory chapter. A loan of 100 per cent. is granted because such a firm has built up for itself an unimpeachable credit standing.

One factor towards the general establishment of credit is the willingness to disclose to bankers the private figures of your business. The manager of a London branch of the Guaranty Trust Company of New York said on this subject:

"We make a speciality of our Credit Information Bureau. I frequently ask firms for their balance-sheets. And I find that there is now a growing willingness on the part of responsible firms to furnish us with this vital information. If a firm has nothing to conceal, it should not object. If a firm refuses, there is always the feeling in the mind of the banker that such a firm must have something to conceal.

"And I need scarcely tell you that bankers are in the habit of exchanging credit information at their respective headquarters. We ourselves are ready to furnish credit information to the British banks, and the British banks are equally willing to reciprocate, so far as the law of banker and client allows. If any banker meets with refusals on the part of a firm to disclose its vital figures, this information is likely to be spread around amongst the banks, and it means that the credit of the firm in question may become open to suspicion."

In the case of a business man whose trading extends beyond the British Isles, it is an advantage to have an account with a foreign bank as well as with a British bank. A very large firm may carry accounts with half-a-dozen banks, not only because these banks have branches in foreign countries, in the cities where the customers are located, but also because it establishes half-a-dozen possible avenues for raising loans on commodities or discounting bills receivable.

The smaller firm will also do well to have a couple of such banking accounts. But it must always be remembered that bankers expect—and rightly expect—perfect frankness as to their customers' borrowings from other banks. For instance, the bank manager quoted above said:

"Suppose a customer comes to us and asks for a loan of £20,000 on some commodity of his in transit from the United States. We know that he also banks with, let us say, Lloyds. We should ask him if he is carrying a loan with them, and to what amount. And, naturally, from time to time we should exchange information with Lloyds as to the man's total liabilities, so as to make sure that he was not *over-extending* his credit."

In the case of a very large firm of good standing its total borrowing may at times be far beyond its immediately *realisable* resources. The risk is carried by the banks on the strength of the firm's "good name."

And the same applies (of course in lesser degree) to a smaller business with a "good name." Once it has established its integrity and its general business capacity, it can look to its bankers for short-term financing extending considerably beyond its working capital.

Looking Forward to Future Bank Loans

Every business man should regard his bank as a potential source of loans which may be needed in the future conduct of his business. Either long-term loans; or short-term lendings on commodities; or the discounting of bills receivable.

Every business needs these at one time or other And one cannot begin too early to win the confidence and friendship of one's banker, so that he will look upon one as a good "moral risk."

The big sound men in business do not hesitate to confide in their banker. They consult him and seek his advice. They treat him in the light of a very valuable business associate—almost a *partner*.

And a smaller firm can well follow that lead.

The line of thought in winning the confidence of a banker runs in this direction:

On opening a bank account, secure an introduction from someone who is already favourably known to the banker. It helps to establish confidence right from the start.

To build up goodwill, do not make a habit of constantly "pinching" the balance in your current

account. Remember that the bank expects to have the free use of some money of yours from time to time, just as with its other depositors. If every depositor kept his balance at almost zero, the bank would have no money to lend to anyone!

If you can manage to introduce other customers to your bank, do so. Every branch manager is expected by headquarters to build up his branch, and etiquette forbids him to solicit directly. He depends on customers coming voluntarily to his branch, and especially by recommendation.

Do not expect to *take* information from your banker without *giving* some information in return. A keen banker wants to hear anything of general interest about trading conditions. Every item of real trading news helps him to increase his knowledge and his value to his bank.

If your banker asks for a statement about your business, let it be clear and complete. Evasion is likely to be fatal, because most bankers can "sense" that there are hidden facts.

In the balance-sheets of the sound industrial companies with a thoroughly good name, one will always find substantial amounts written off every year for "depreciation," and heavy sums placed to "reserve." Sometimes there are several reserves earmarked for different purposes—"general reserve," "depreciation reserve," "dividend reserve," "bad debts reserve," "contingencies reserve," and so on.

This is the kind of statement which a banker delights to see. And while a young business man obviously cannot present such an impressive array of figures, yet he can do this: (*a*) Forbear to draw all his annual profits out of the business; (*b*) put some of them back

into the business; create a reserve; (c) show that he is not living only for the moment, but is making prudent provision for possible "hard times" in trading.

A banker is by training cautious and conservative. Therefore he admires caution and conservatism in others. He is accustomed to "take a long view of things." Therefore he respects prudent foresight in his customers.

Insurance policies are always splendid security in the mind of a banker. And in addition they spell to him prudence and foresight.

Deposit your policies with the banker for safe custody. As you pay the premiums, turn in the receipts to him. Each time you do so you will be reminding him of your prudent provision for the uncertainties of the future.

Show the Banker a recent Balance-sheet and Next Year's Estimated Balance-sheet

In negotiating a bank loan study and understand the mental attitude of a banker and the requirements of a bank, both for short-term and long-term loans.

Prepare for a loan negotiation long before you need it—years before. And ask for the loan before it is actually urgent, so that you are not in the weak position of having to secure it at any cost.

Be ready not only to show a recent balance-sheet of your business, but also an estimated balance-sheet for the coming year. The future condition of your business may be of as much interest to the bank as your present position.

CHAPTER VI

Raising Additional Capital for a Young Business

SUPPOSE a manufacturing business has been established for a couple of years, is healthy, is showing a good profit, and is now looking for extra capital to extend and make still bigger profits.

This proposition, unlike that of a totally new business, could be offered to a bank. And here is the attitude towards it of the manager of one of the chief branches of a large joint stock bank in this country:

"We are prepared to lend money in such a case, on the security of a 'floating charge' on the assets of the business—freehold or leasehold rights on desirable property; the building thereon; the machinery and fixtures; the raw material in process of manufacture; the goods in stock; and the bills receivable.

"The land, the machinery and the fixtures would, of course, be valued by our own appraisers. In the case of land we would advance two-thirds of its appraisal value. The factory and plant are of a different order of risk, because their value lies in their being a going concern. A dead factory is of very little value. The security offered by raw materials and goods depends, of course, on their nature, and varies very greatly according to their market ability and the fluctuations to which they are subject. We might consider them as worth anything from 50 per cent. to 90 per cent. of their cost price, in this connection.

"There is also another class of security upon which we are prepared to lend—uncalled capital of a limited company. Suppose, for instance, that the company has issued £1 shares, 10s. paid and 10s. callable at some future date, at the option of the directors. We should consider this 10s. of uncalled capital as an asset on which money could be advanced, if backed by the guarantee of the directors jointly and severally, and protected against the issue of debentures in front of it.

"Our floating charge on the business must rank before everything else. A bank does not play second fiddle. We must have a prior claim on the assets of the firm, and in the case of a limited company we prefer that the loan should also be guaranteed by the directors jointly and severally.

Factors which Influence the Bank in Extending Credit to a Business

"If a second mortgage be raised on any form of property on which the bank holds a first mortgage, this at once revises our valuation of the first mortgage, and we might ask the owner to settle his loan with the bank and go elsewhere for his money. The reason is a peculiar one, not generally understood by those who raise mortgages, and in effect it comes to this: If a borrower in the ordinary course of his banking transactions pays back some of the money-on-loan one month, and asks for it to be re-loaned to him next month, the re-loan would rank after the second mortgage in law, and would be a bad risk from the banker's point of view. This ought to be more widely known by borrowers.

"We never loan money for long fixed periods. We retain the right to call in a loan at any moment—and

though, of course, we always endeavour to deal with the borrower in a spirit of fairness and equity, yet the bank's right exists and should be thoroughly realised by the borrower.

"The above deals only with materialities—the estimate we should form of the assets of the business as expressed by property, plant and other material security. But, of course, the *character* and *integrity* of the business man who asks for the loan is a very important factor. It would weigh heavily in the recommendation which the bank manager made to his Loan Committee. We have to consider the 'moral risk' as well as the 'material risk.'

Internal Conditions which Affect the Giving of Credit by a Bank

"It is, of course, well known that in the case of a joint stock bank, all loans are passed on by the Loan Committee at headquarters. Small loans, say up to £1,000, usually pass automatically. Larger loans are considered not only from the point of view of the recommendation made by the local manager, but also from the point of view of the *bulk total* of requests made by the branches all over the country.

"Hundreds of branches are sending in their recommendations for loans every day. The Loan Committee has to consider the *total* of such loans in relation to its deposits or floating cash. If the bulk of the loans asked for at any given moment is too heavy, then it means that some of the loans must be refused—*not because they are bad securities*, but because of the general condition of the loanable funds of the bank at that moment. If a selection has to be made amongst such requests for loans, then obviously they will be

allotted to customers of old standing for their normal trading requirements, rather than to the expansion of young enterprises. It is absolutely essential in the conduct of a bank of hundreds of branches that the loans asked for should be considered in this double light by the Loan Committee at headquarters, viewing the business of all the branches as a whole."

It is clear that the manufacturer with a young and growing business can confidently go to a bank for extra capital, but the conditions are liable to be stringent—a floating charge on all the assets of the business, ranking in front of everything else. If he wants to raise money less stringently, he can do so by turning his business into a limited company, and—

1. Selling ordinary shares; or
2. Selling preference shares; or
3. Selling debentures.

Assuming that his balance-sheets are sound, and that he has a sufficient circle of friends and acquaintances likely to invest money with him, the choice of the three above alternatives would depend on the use to which he wants to put the money, as well as the general condition of the investment market.

In times of acute depression, investors are looking first and foremost to *security*. They want to be sure that their money will be *safe*. Rate of interest or amount of dividend is secondary. In times such as we passed through in the first half of 1922, for instance, investors will rush to buy debentures, forming a first charge on the assets of a business; and may invest freely in preference shares which seem quite safe to pay a fixed dividend—while they will ignore the allurements of an ordinary share offering the possibility of

20 per cent. or 30 per cent. This is well known to city finance houses.

On the other hand, if issues are made in times of increasing business confidence, then the psychology of investors in general is to put their money into ordinary shares which offer both a prospect of substantial interest and an appreciation of the market value of the shares.

How to Make a Market in the Shares of a Private Limited Company

In the case of a private limited company or a small public company, an obstacle to obtaining investors is that there will be no "free market" in the shares. A share in such a company might be thoroughly worth its par value or more, but it will not be easily realisable. The way to overcome this objection is for the company to create its own market in its own shares. They announce beforehand that the secretary of the company will keep a register of shareholders ready to sell and of enquirers ready to buy such shares, and will bring them together. Some companies help this marketing by actually purchasing themselves the shares which come on offer, but, to comply with legal formalities, they buy them on behalf of a nominee, such as the solicitor to the company. In brief, they put the buying and the selling of the shares in their company through a "nominee account," and this has the effect of making the shares more realisable.

If times are good, and it is possible for the young business to place either preference or ordinary shares, then the question of which to issue depends broadly on the following considerations:

If the money is wanted for the purpose of factory extensions, or extra machinery, or material improve-

ments, these are tangible security for the investor, but may not actually pay for themselves for many years to come. In this case the issue had best be in debentures or preference shares carrying a small fixed dividend.

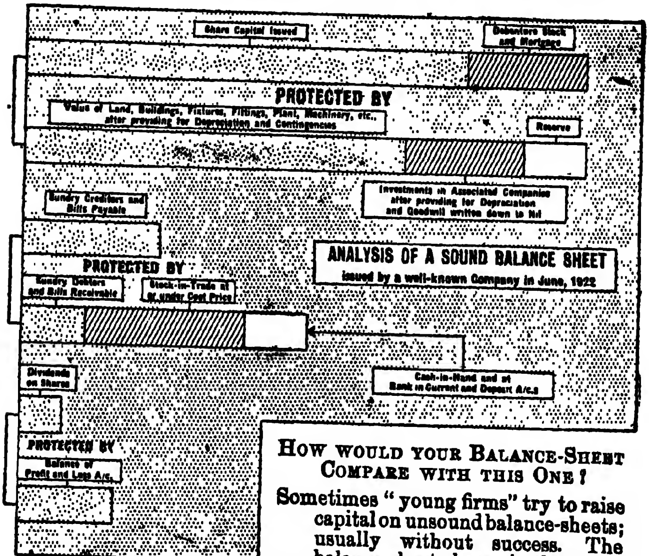
On the other hand, if extra capital is needed because the turnover of the business is too large in proportion to working capital—*i.e.*, if the extra capital is to be put into raw material or goods which can be expected to return a profit *in a short time*, then the issue should preferably be in ordinary shares. Raw material and finished goods are possible profit-makers within a short period, and form a legitimate basis for ordinary shares on which the investor has an expectation of big profits, and at the same time accepts the risk of losses. With debentures or preference shares, he expects fixed and enduring assets behind the issue. He expects a small safe dividend without the risk of losses.

How one Unsound Balance-sheet was found out by Expert Accountants

In the case of a young business, the issuing of shares must of course be done locally or within a specialised circle of prospects. By "locally" is meant the business man's immediate circle of friends and acquaintances, and the people in his town and district who will benefit by the success of his venture. An increase in the size of a factory means more employees, and more money spent locally for rent, food and clothing. The manufacturer could therefore approach the owners of local property and local traders, and offer them shares from which they would profit in two ways—directly in dividends or interest, and indirectly through increased local demand from those on the pay-roll of the factory. By "specialised circle of prospects" is meant the

supply houses and manufacturers who sell raw material or machinery to the factory, and the wholesalers and retailers to whom the factory sells finished goods.

It has been assumed all along that the balance-sheets of the young business are sound and will stand the scrutiny of experienced business men. All sorts of



HOW WOULD YOUR BALANCE-SHEET COMPARE WITH THIS ONE?

Sometimes "young firms" try to raise capital on unsound balance-sheets; usually without success. The balance-sheet shown in this chart is the kind of balance-sheet which would be most favourably regarded by bankers.

young firms try to raise capital on unsound balance-sheets. Sometimes they "get away with it." But usually they waste time and energy. Here is an instance of such an attempt:

A firm in Manchester, starting with a capital of £1,000, took up the selling of some speciality articles, advertised broadcast, and within eighteen months had

sold £20,000 worth. The gross profit was £11,000. The above figures were certified by an auditor. The *net profits* were not certified, but were stated to be in the neighbourhood of £6,000 in eighteen months. On this showing they asked for extra capital to extend their business.

An investor who was approached on the above proposition dug out the following facts. First, the original capital of £1,000 had been supplemented by a loan of £10,000 from a friend, who was now asking (perhaps even pressing) for the return of it. Secondly, the stock in hand was valued at £13,000. Thirdly, the articles on which the business was built were threatened by the competition of similar speciality articles at a much lower retail price.

Therefore money put into that business would probably go to paying off a £10,000 debt; to financing a stock of goods far in excess of what should be carried by such a business; and to the highly speculative chances of the firm being able to sell these articles against competitive lines offered to the public considerably cheaper. The business man's answer to an offer of shares of this kind would clearly be: "Sell off your stock of £13,000 worth of goods, if you can; then pay off your loan of £10,000, or part of it; and use the remainder for working capital."

In the selling of shares a young firm will be considerably assisted if their bank manger allows reference to himself from the people whom it is proposed to interest in the shares.

A bank manager cannot undertake to place shares, but if he has known the business man for some years, believes in his integrity and general business ability, and is satisfied with the balance-sheets submitted to him,

he will in most cases be prepared to give a verbal recommendation of the enterprise to those who come and ask him for his opinion.

On the other hand, the kind of balance-sheet which would be looked upon with favour by a bank or financier is the kind shown in the chart accompanying this chapter. The main items of the balance-sheet are illustrated proportionately by the length of the columns.

It will be seen at a glance that the share capital issued and the debenture stock and mortgages are fully protected by the value of the land, buildings, plant, etc., investments in associated companies, and reserve, whilst goodwill, which often figures so heavily as an asset on the balance-sheets of some firms, is written down at nil.

Money owing by sundry debtors is much smaller than the amount owing to sundry creditors; and you will note that the latter item is protected twice over by the combined value of the sundry debts, the stock-in-trade, and the cash in hand and at bank.

Dividends on shares, paid or payable, are protected twice over by the balance of profit and loss account; or, in other words, a substantial sum can be placed to reserve or carried forward to the next profit and loss account.

There is essential *soundness* in the proportions of the various items.

CHAPTER VII

Raising Additional Capital for an Old-Established Business

IT is not proposed to discuss here the raising of capital by concerns of national reputation, but a case of more general interest—that of a medium-sized or small old-established business, favourably known to a restricted circle, but not widely known to the general public.

Such a firm has three main courses open to it:

1. Issuing and placing debentures.
2. Taking in a sleeping partner with capital.
3. Making a public issue of preference or ordinary shares.

The first is the more obvious and the easier course. If the debentures are well secured, a bank will probably take them as collateral for a long-term loan. And there are many solicitors—mostly conveyancing lawyers—who make a speciality of bringing together firms with debentures (or mortgages) to offer, and clients who have money to invest in sound securities paying a rate of interest above the ruling rate for money.

But such a course does not usually solve the problem. The money required is beyond what can be raised on debentures.

Then comes the possibility of taking in a sleeping partner. It is always practicable to find offers of this

character through the medium of a newspaper advertisement, a solicitor, a chartered accountant, or a partnership agency. But "the rub" comes in the terms of the partnership. The firm want him, in effect, to buy a large slice of their "goodwill" reckoned at a lavish figure. The prospective partner, if he is a keen business man or is well advised, is sceptical about the value of goodwill, and wants to put down his money for the *results of future trading*—the actual profits to come.

In brief, obtaining capital by means of a new partner generally means having to part with a big share of the profits.

The bold course for getting money cheaply is to convert the firm into a limited liability company (assuming it is not such already) and to make a public issue of shares.

The Type of Director to Select—and to Avoid

A business of the type we are considering—a small, old-established business—usually has on its board members of the family and a few specially favoured employees who have been given posts as directors. These latter are practical men, and highly useful in the business, but their names do not carry weight with the public.

It is essential to add some names which *are* widely known. *Not* guinea-pigs. The day is gone by when the name of a lord or a colonel carried full confidence with the public. What is needed nowadays is the sound business man who has made a success in business—not necessarily in the exact trade of the firm issuing the shares, but preferably in some allied trade—a man who is able to influence business for the company, either in the purchasing end or the selling end.

The tendency of to-day is directly towards *consolidation* of trading interests. By this is meant consolidation with a firm in the same line of business, or with firms who supply raw material or semi-finished articles to the company.

Either this is a definite amalgamation of interests, or it is partly secured by having on the board a man or men with a large amount of control over the other firms. The public are quick enough to see that such a consolidation of interests will probably lead to bigger profits. They will be inclined to accept a statement as to its value in the particular case of the company which is issuing the shares.

It cannot be too much emphasised that the nature of the shares to be issued must depend on the general psychology of the investing public at the time of issue. During the slump period of 1922, we saw the public lining up in queues to have the privilege of offering their subscriptions for debentures and preference issues. And during that time there were several cases of issues of ordinary shares from businesses headed by well-known and successful names, and offering good chances of large profit, which were complete failures.

The investing public is a "crowd." That is to say, it follows the general psychology of a "crowd." It is highly suggestible, and readily influenced by force of contagion. It runs after the same thing as other people are running after. At one time, the word "rubber" was sufficient to draw subscriptions for any sort of prospectus. At other times, "oil" was the irresistible magnet. At another period, "re-insurance." In another era, it has been "debentures." If times are "good" and general business confidence is the order of the day, then the public undoubtedly favour some

form of speculative business risk—*e.g.*, ordinary shares in a business which seems to have the prospect of increasing trade and rapid profits.

City people, acquainted with the psychology of investors, recognise that it is necessary to *swim with the financial current.* There are "fashions" in shares. And any company wishing to get extra capital from the public must needs fall in with the prevailing fashion.

As to the exact title of the issues, ordinary shares are sometimes camouflaged nowadays under the title of "cumulative participating preference shares." It is much the same thing, but has a more attractive sound.

Shares can be issued at so-much paid and so-much callable at the discretion of the directors. This is an important point. From the company's point of view, "callable" capital is an asset on which a bank will, if necessary, lend money. It is thoroughly worth while discussing with those acquainted with the flotation market, as to whether this matter of "callable" capital can be incorporated in the proposed issue.

These Points must *be Watched in Preparing a Company Prospectus*

The owners of the firm are, of course, always anxious to get a considerable amount in cash out of a public issue. But nowadays the investing public, guided by the financial columns of the newspapers, look very closely at this point. When the owners of the firm are content to take their portion entirely in shares of the company, it is nearly always commented on favourably by the newspapers, and therefore helps considerably towards the success of the issue.

Reports on the past trading of the company and its future prospects cannot be worded too carefully. The

man reading the prospectus is always inclined to question the signed statement of someone already in the firm and directly interested in the success of the quotation. He is also suspicious of reports of technical experts of merely local reputation. But a signed statement from a technical expert of national reputation, and a signed statement relating both to past figures and future estimates, from a firm of accountants of national reputation, will go far towards convincing the public of both the *bona fides* of the company and the prospects of future profit. Nor is it always convincing to refer to the figures of firms in the same line of business. The financial critics in the newspapers usually condemn a statement of that kind, and warn their readers against it.

Another point closely watched by the public is whether the directors of a new company are "playing safe" by allowing themselves the right to go to allotment on the statutory "seven shares," or whether they take their courage in their hand and state boldly in the prospectus that they will not proceed to allotment unless one-half at least of the issue is subscribed for. Confidence begets confidence!

It will always be a strong point in a prospectus if it can be stated that "nothing has been included in the assets for the trade marks and goodwill of this old-established business."

The Capitalising of Goodwill

And this leads to the consideration of what "goodwill" actually means, and if it can be translated into material gain. Very many old-established firms place a high figure on their "goodwill," and enter such figure in their balance-sheets year after year. On the other

hand, certain of the very largest and most successful companies treat goodwill as a "hidden reserve," marking it down to nothing in their balance-sheets.

Goodwill is supposed to represent a future trading profit due on past performance. It presupposes a state of fairly normal trading conditions, and an increasing turnover on the part of the firm. But when normal conditions are shattered, goodwill may vanish as a profit-bringer. If the products of the firm become too high in price, if the ultimate consumer cannot *afford* to buy them, then he will *not* buy them. The goodwill possessed by the firm will not force purchasers to buy beyond their means, or at a price higher than competition from other parts of the earth.

If goodwill really exists, it can be capitalised by an offering of shares to the shareholders, or the customers and connections of the firm, those who have dealt with the firm for years past. This is *the acid-test of goodwill*—whether it has been so implanted in the customers of the firm by previous fairness of trading, that they will, when asked, entrust their money to that firm.

In any issue such as we have been discussing, the placing of shares amongst the customers and connections of the firm should be regarded as the most likely source of capital, *and reached for in a way special and distinct from the offering of the shares to the general public.*

CHAPTER VIII

How to Negotiate a Bank Loan

THE attitude of a branch manager of a joint stock bank has been defined in general terms in preceding chapters. May I repeat—he has to make his recommendation for a loan to a Loan Committee at his headquarters; and he has to base his recommendation on certain broad lines already laid down for him. His acceptance or rejection of your request for a loan will be in accordance with very conservative and very sound principles of banking.

Success in obtaining loans from a bank therefore depends on shaping the figures of one's business, and making one's request, in a form in which the banker sees them as a desirable outlet for the loanable money of his bank. He wants to base the loan on the security of assets which can be turned into cash, if necessary, very quickly. He does not want to tie up the bank's money in a loan of indeterminate length. He prefers short loans. He would like you to "clear up" your loan account at least once a year and start afresh.

Here are some of the questions which a bank manager might ask the first time one made a request for a business loan:

Have you brought with you your balance-sheet and profit and loss account for the last twelve months, and for the preceding twelve months? Are they duly audited and certified by a chartered accountant?

How long has your business been established? What are the net profits year by year for the last five years?

How much do you want to borrow?

For what purpose do you want to borrow it?—The purpose is most important. In times of abundant business prosperity, the bank manager might be glad to hear that you proposed to devote the extra money to an extension of plant, or to an extension of your selling organisation, or to an advertising campaign. But if the times were such that he felt the general trade outlook as uncertain, he might consider that any of the above were unwise, and likely to jeopardise the general soundness of your business. On the other hand, if you are not contemplating any spectacular expansion, but are needing money in order to put in a more efficient type of machinery, or to improve your methods of storage and handling and rapid distribution—if you are looking to larger savings rather than larger sales, he might be favourably impressed with your business prudence.

How are you proposing to repay it? In one sum or in instalments?—A bank manager likes to see that you have in mind a definite date of repayment, and a definite idea of where the money with which to repay is coming from. If the loan is granted on a "floating charge" on all the assets of a business, which you expect to let run for a considerable time, it should be emphasised again that a bank does not want to lend its money for "working capital" to be used in the expansion of a business, in the manufacture of new lines, or in rapid development of sales, unless the times are very propitious.

A bank prefers to lend money for the purpose of helping out the financing of a seasonal trade—*i.e.*, to

finance the needs of a business which runs at a loss for part of the year, and makes big profits the other part of the year. It looks favourably on the business which requires cash to help it over the difficult part of the year, and can confidently expect, on the basis of past trading results, to pay back that loan to the bank during the time when money is coming in freely.

What are your *biggest* assets?—On looking over your balance-sheet, he would first of all make a rapid calculation of what your assets might be worth at a "break-up price," in case of catastrophe, and how much could be quickly turned into cash under ordinary conditions. He would prefer to see the share capital of a limited company in the form of ordinary or preference shares rather than debentures, because debentures have the first claim on the assets of a business, whereas preference shares and ordinary shares rank for distribution of assets *after* a loan granted by a bank. And this means that in the general shaping of the figures of a business, with a view to obtaining loans from a bank at some future date, one would be wary about raising money in the form of debentures, if it is at all possible to secure the same capital in the form of an issue of preference shares. *The bank will want to inject its mortgage in front of everything else.* "A bank never plays second fiddle."

Are the directors of your company prepared, jointly and severally, to endorse your company's paper?—This is a point upon which banks are usually insistent. They know that companies can be "manipulated," so that they run to seed, while at the same time the directors as individuals wax fat from fees and bonuses awarded to themselves by themselves. A bank wants to feel that it is lending money on the security of individuals as well as on the general security of a company.

What security have you to offer?

Any or all of the above questions may be put in the case of a loan or overdraft asked for on the security of a "floating charge" on the business. If it is not desired to give this "floating charge," but only to mortgage a specific asset like goods or raw material, the banker will want to be sure that these are readily saleable in case of emergency. For instance, leaf tobacco of a standard grade has a world-wide market; but cigarettes manufactured from that same tobacco may have a very limited market. If manufactured in large quantities, cigarettes are liable to become "frozen." Similarly, wool of a standard grade may be saleable in many parts of the world, whereas woollens, manufactured in the piece, may be difficult to dispose of.

The Facts on which the Banker Makes his Decision re a Proposed Loan

The banker has also to take into account possible fluctuations in the price of raw material. He may want a margin as high as 50 per cent.; and if the security offered is a bill of exchange, he will allow himself a margin of 25 per cent. or more. And it must also be remembered that when a bank grants a loan on the strength of raw material or goods, it does not take this as the *only* security for the loan. To guard against complete collapse of price, below even the 50 per cent. it has reckoned on, it expects further security in the form of a general or personal guarantee—*i.e.*, it wants recourse to your other assets; and it will be found that this is set out formally in the loan agreement.

Over and above all this, the banker will be forming his own judgment on your general capacities as a business man, your reliability, and your integrity.

He will not be impressed by glowing generalities of future prospects. He wants to see what you have done in the past, in the cold light of the figures of your business as certified by a chartered accountant. These figures speak to him in a language he very thoroughly understands. They give him a bird's-eye view of your business. They show him the strong points and the weak points—from the aspect of whether your line of business-building has been sound and prudent, and adjusted to withstand slump-time as well as expand in boom-time. He will look to the amounts by which you have "written down" plant and machinery, furniture and office fixtures. The granting of a loan will not depend on "talk" as to how one intends to push forward and make big profits. The best way, in fact, is to say very little; let the banker ask any questions he pleases about your business; and answer them simply and frankly, without ornamentation.

This being so, the right way to negotiate a loan is to prepare for it years ahead. Your accountant, if he is a capable man, will tell you if your yearly balance-sheet is looking sound from the financier's point of view. And if it is not looking sound, he will tell you what ought to be done, in your particular case, to shape the figures for the future in a direction which will convey to the banker a feeling of your soundness and prudence. A turning-round of this kind cannot be done in a short space of time. It usually takes years to put a business into such a shape that a bank will be eager to lend money to it.

CHAPTER IX

How to Strengthen and Extend your Credit Standing

BY CECIL CHISHOLM,
MANAGING EDITOR OF "BUSINESS"

YOUR credit standing finally depends on three things: your reputation for integrity, the material resources you can show, your past record as a payer.

In a young business the last is probably the most important factor in strengthening your credit standing and enabling you to expand your credit. In other words, your creditor asks himself three questions in this order: Has he paid me according to his promises in the past? Have I trust and faith in him? Has he the money to pay with?

For your creditor knows very well that unless you want to pay, you won't pay promptly. He also knows that unless you have money to pay with, you can't pay. But the whole thing is pretty much summed up in the belief that if you have paid in the past you will in the future.

Credit is like muscles: unless exercised they do not gain strength. Having a lot of money in the bank and material resources no more ensures a man having good credit than a heavy weight of fat in his arms assures him of muscular strength.

The first necessity, therefore, to build up your credit

standing is to use your credit. A certain firm which has high seasonal activities, counterbalanced by a dull period, makes all its purchases contracts on the terms that it shall have the usual discounts allowed in the trade for payments in ten or thirty days; but at its own option it shall have the choice of paying ninety days net. During the active season it discounts its bills; during the dull season it frequently takes the full limit of its credit. But even in years when it paid on discount terms every month, it still kept the alternative terms of payment in all its contracts. The result is that nobody queries it at all when this firm takes its ninety days; and it is in a position at any moment to extend its credit from one to three times the normal.

How One Small Business has Built Up a High Credit Standing.

Another business has done much the same in establishing its credit with its bank. It operated for a time without any advance. Then it asked for a small overdraft, and got it with some difficulty. During the next prosperous season this firm invested its surplus in government securities. It took the first opportunity that came along, when ready cash was needed, to use this government stock as security for a large advance from the bank; this was paid off in due course. The next step, taken a little later, was to get an overdraft from the bank merely on the basis of the directors' guarantee; and a little later still a loan was secured with warehoused goods as security. The result is that this business now has a credit in its bank good for several thousand pounds.

No firm builds up a good credit standing by *always* taking the longest possible time for payment. It may

think it is securing long credit and using the other fellow's money by doing so, but if the facts were known it would probably appear that the firm has to pay for this extension of credit by being charged higher prices or by missing discounts. It is by ordinarily paying promptly, but always reserving the right of longer terms of payment if necessary, that a good credit standing is created.

There is nothing which enhances the credit standing, especially of a young firm, so much as gradually and steadily reducing the period of payment until it reaches the stage of paying promptly on the discount or net date. Its creditors will be watching this improvement and will get the impression of gathering strength and stability. It is surprising how a period of prompt payment will carry a firm along, even through a subsequent period of longer terms of credit. The remembrance that the credit of a firm was once good dies out very slowly.

To gain a good credit reputation it is not, however, necessary to pay on the discount date. What is necessary is that payment be made on the stated terms and when promised. It is worse for the reputation of a business to undertake to pay within ten days and then run over to forty days before paying, than it is to undertake to pay within three months and then to pay promptly on the ninety days. The latter makes for a stable credit standing; the former creates doubt.

Always to live up to your promises of payment is therefore the very first rule in establishing a good credit standing. The time to deal with the date of payment is when you make the purchase. If you know you can pay promptly, agree to it, and then do it. If you know you cannot pay promptly, get the terms

fixed plainly at thirty, sixty, or ninety days when the order is placed. If you are not absolutely sure one way or another, then, as pointed out in the illustration above, allow yourself fixed options in the terms of purchase.

But even so, unforeseen contingencies arise, and it is not always possible to pay on the date promised. When this happens watch your commitments far enough in advance to see that you know well beforehand that you are not going to live up to your promise. Then, instead of letting the date slip by, in the hope that it will go unnoticed and that you can get an extra fortnight or month for payment, take up the question in advance with your creditor and explain the circumstances to him. You will almost invariably find it possible to secure an extension if you have good reasons and state them frankly.

Remember that knowledge is back of confidence. The first kind of knowledge that your creditor wants is the knowledge he gains from his experience with you—this is *his own* knowledge, and therefore carries most weight with him. The next in importance is the knowledge you give him about your business.

Why it Pays to be Conservative in Arranging Credit

A city firm which does a highly seasonable business—does three-quarters of its business in one-quarter of the year—has for many years secured an overdraft of as high as £40,000 to carry it through its dull period. The proprietor has obtained this accommodation by keeping the bank as closely informed of his business as he has his own directors. The bank knows exactly how his business is carried on, what he buys, whom he buys from and in what quantities, what is his manufacturing period, his selling period, what is his gross margin and

his net margin of profit, what terms he gives to his customers. The bank has had these facts and figures for a period of years, with the result that it feels absolutely certain of the safety of its advances to this business. Such an extensive overdraft to a medium-sized business could never have been obtained without this perfect frankness and informativeness.

Every business man finds it most difficult to be conservative about his own affairs. But in building up a credit standing, ultra-conservatism brings handsome returns. It is much better to arrange for ninety-day terms and then to pay within sixty days than *vice versa;* and it is often just as easy at the beginning to ask for ninety-day terms as it is for sixty days. To arrange with a bank for an overdraft of £5,000 and to use only £3,500, is better for your reputation than to arrange for a loan of £3,500 and then ask for a further increase to £5,000. Both the bank and the credit supply house like to have this double feeling: that the debtor knows his business and has a firm grasp of it, and that his word can be absolutely relied on.

A high-grade standing with three or four firms is much better than a weak credit standing with thirty or forty. In selling goods it is often the best policy to spread one's outlets and to do a small business with many customers rather than a large business with a few customers. But in getting credit the opposite is more true. The supply house feels much safer about an account if it knows that the debtor has not scattered his purchases here, there, and everywhere; whereas a bank will often not extend a loan at all unless it is understood that it shall be the only bank creditor, for it feels that it then has a better control over the account. It is also a fact that a creditor is bound to take more

interest in a large account than in a small one—to nurse it longer, to give it his time, attention and aid. On the other hand, the debtor has fewer people to deal with and therefore has a simpler problem. A host of small debtors are much more likely to press a business man and force their claims than two or three large ones.

No Means should be spared to Prove your Stability to your Creditors

You should spare no means to prove your stability to your creditors. Use every honourable method within reach to have credit brought to you, and remember always the importance of little details in establishing a credit standing. Superficial appearances are not to be overlooked: it is no more a good policy to neglect superficial appearances that bring you enhancement, than it is to concentrate on superficial appearances without sound backing. But on these details careful judgment must be exercised. Extension of credit can sometimes be secured by a bold front being presented, handsome offices, and the use of a high-grade letter head; but many a firm that deals with a few large customers who are bound to know the inner facts of the business has aroused suspicion among its creditors and damaged its credit by doing the same thing. One firm had its credit cut off from one of its largest supply houses soon after the slump came for the reason, as frankly stated by the director of the supply house, that it had just previously taken additional factory space, including in it a new and commodious and rather extravagantly furnished office, and the supply house concluded that this showed lack of acumen and possible over-extension on the part of the debtor.

The obtaining of credit is in itself a form of sales-

manship, and a very difficult form. The man who goes to ask for credit must first of all place himself in the mental position of the credit manager. He has to formulate his case, and *then present* it properly. And all the elements that go towards the bringing off of a difficult sale of goods are present in this matter of "selling himself" for extra credit.

One young man did this successfully by first of all detailing all the requirements for increase of trade, as he saw it in his particular line of business; then by pointing out in a judicial manner that his nearest competitors did not possess all these requirements, for such-and-such definite reasons; and then leaving it to inference that *he* did possess them, and could succeed where others might possibly fail. In fact, he had prepared himself for *constructive* answers on all the points he mentioned. He was not merely negative.

Credit is a tender plant. It can be withered in a moment by any mis-statement provably untrue in the ears of the man to whom it is made. It can be nurtured by self-confidence backed by provable statements. And the methods for presenting one's case for credit must needs be studied beforehand from the view-point of the man who takes the credit risk.

The head of a London wholesale trimmings house, selling to retail drapery and millinery firms of all sizes, said on this subject:

"If I have any doubt about a man, I ask him the scale of his personal expenses. So many people unfortunately have an inflated idea of the standard of living they can afford—move to a large house, buy a motor-car, and so on—and go beyond the scale which their business conditions entitle them to. This means that the money they ought to put back into their business as

'reserve' will be spent in personal expenses. If an applicant for credit can show me that he is not extravagant in his personal needs, it will make me favourably inclined towards him.

"And another thing we very much appreciate is straight trading methods. Some retailers, if they find that they cannot sell goods as quickly as they anticipated, will send them back to the wholesaler with all sorts of excuses—'not up to sample,' 'inferior finish,' 'arrived in broken condition,' and so on. We wholesalers know perfectly well that these are sometimes mere dodges to evade a business contract. But they are difficult to prove as dodges, and frequently we are forced to take a loss on them. It means, however, a 'black mark' against that retailer, and, when he comes to ask for any special favour, we remember.

"On the other hand, I know cases where we have, by mistake, sent extra goods in a man's parcel without invoicing for them, and the man has been straight enough to write and tell us of the mistake in his favour. And, of course, we remember that, and are ready to reciprocate in the future.

"Some retailers also try to squeeze an extra month's credit out of us by asking for goods to be invoiced as '20th to 20th,' instead of '1st to 31st' If we grant this, they mostly take very good care to order the bulk of their goods after the 19th of the month, so that goods sent to them on (say) April 21 are not paid for by them until July 1."

Keeping Credit Good

The way to keep credit good is never to abuse it. While it is valuable to test your credit now and then by asking for and taking longer terms, there is nothing

to be gained for the credit standing by *repeatedly* taking long terms and repeatedly delaying payment. Even if such long terms and such delays are permitted to go on by the creditor it does not improve the debtor's credit standing. It is conceivable that the firm which pays on the discount date seven times out of ten, and the other three times takes longer time, but on previously fixed terms, might get even a year's extension in an emergency; whereas the firm which is habitually behind always finds it most difficult to secure even the slightest extension of terms.

As in the case of friendship favours, payment is always trebly welcomed when it comes without being asked. It is much better for your credit standing to arrange in advance for ninety days and then pay on the eighty-fifth day, than it is to arrange for thirty days and pay on the thirty-fifth day after a reminder has come to hand.

This chapter may well begin and end with an emphasis on living up to your undertakings. Generally speaking it is better to pay promptly if the money is at hand; but it is really a matter of knowing the needs and obligations of your business so accurately, and having such an efficient day-by-day financing system, that what you originally promise you can ultimately fulfil, and that you do not repudiate any promise you have made.

CHAPTER X

How much Capital does a Business really require?

BY JOHN A. CRABTREE,

MANAGING DIRECTOR, J. A. CRABTREE AND CO., LTD.

IT requires a spirit of adventure to start a new manufacturing business in these days. When, in 1919, I first set out to build this business, I would have given much for any sound and reliable general guide. For what they are worth, therefore, I propose to set down some of the earlier problems which confronted us and to show how we surmounted them, in the hope that our experience may prove of service to others.

There is an old Latin saying "Omne trinum perfectum"—there is a trinity in everything perfect. It certainly applies to a new business, which may be likened to a tall, carefully poised tower, stayed by three ropes. Any one of these three stay-ropes affects the other two, and the ultimate success of a business must depend upon the efficient balance of the three. For example, an over-ambitious scheme of production may pull over the business on account of insufficient capital and weak organisation and policy to balance it. On the other hand, an inflated and excessive capital may do the same from its own side. You have only to imagine the stress that any one stay can throw on the other two, by being out of balance, to recognise that a bad trade wind

straining the structure from the weakest side may topple over the whole construction.

Years of sound business trading bring the three stays into absolute balance. But the prime difficulty at the start is to produce this balance by deliberate planning and calculation.

Having decided to start for ourselves, the first question was: "How much capital shall we require?" It

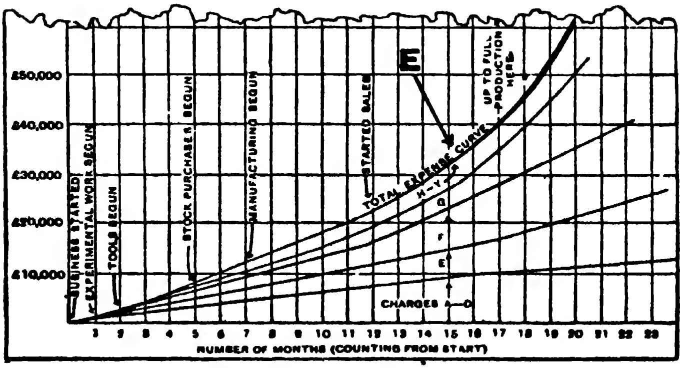


Chart which shows the major and minor sources of expense in relation to the time programme, thus giving a basic expense curve necessary to the determining of the capital required.

could not be left to chance or experience to teach us. We must *know* beforehand to start on a sound basis.

I believe most emphatically that sound estimated costs must be the basic foundation of a business. Any serious preliminary error may throw the whole business out of balance, starving you for essential capital, or leaving you to manufacture at a loss. For, mark you, errors are almost invariably against you. We frail humans are prone to error, with a general tendency to ignore the possibility of trouble.

In the majority of businesses, the amount of capital at the directors' disposal is the controlling factor in ultimate costs. It serves as a rough indication as to the general policy to adopt, and governs the limits within which the whole proposition must be laid down. For instance, no one would dream of mass producing motor-cars (as we understand mass production) on a £50,000 capital. On the other hand, £50,000 would go a long way towards the mass production of chandelier-chains, and possibly leave something over.

The proposition having once been drafted within broad limits, the whole scheme of production demands a careful analysis. In our own case we endeavoured to anticipate as far as possible such items as material, labour, tools, plant, general overheads, and every conceivable item of expense. Matters were complicated for us by reason of the fact that we had to produce certain articles (small mechanical household accessories) which, though similar in general appearance, yet cost very different prices in fact, by reason of the difference in demand, and consequent difference in manufacture. Added to this, our product, possessing new features, demanded entirely new methods of manufacture, which were extremely difficult to estimate in cost.

Comparisons had to be made between various types of plant, bearing in mind the effectual balance of production and the avoidance of bottle-necks. This balancing of plant is too important to be handled in the space here available. Obviously, in working out our costs along such lines, several different methods of manufacture were developed. In the end we found ourselves with three alternative costs, which we averaged for the sake of safety.

Arrived at this stage we had now formed a fairly clear idea as to:

(*a*) Probable plant and equipment. (*b*) Probable output and turnover. (*c*) Probable prime costs (material and labour). (*d*) Probable general organisation and layout.

The next job was to map out a time schedule in which the various work was arranged to synchronise as far as possible. For example, dates were estimated for the following:

Factory ready for equipment.
Equipment completed.
Stock purchases commenced.
Experimental work completed.
Tools completed
Manufacture of product commenced.
Finished deliveries commenced.
Full output reached, etc.

In addition to these matters, the following questions of commercial policy demanded settlement:

1. Quantity of finished stock to be carried.
2. Average credit to be allowed on sales.
3. Average credit to be expected on purchases.

These three items were expressed in weeks of work. Thus a finished stock of £20,000 would be considered as ten weeks' work on a weekly turnover of £2,000.

The general conditions prevailing in one's own trade largely govern the actual settlement of these questions and indicate a fairly definite line on which to calculate.

It was now possible to complete our estimated charges, grouping these under main headings somewhat as follows:

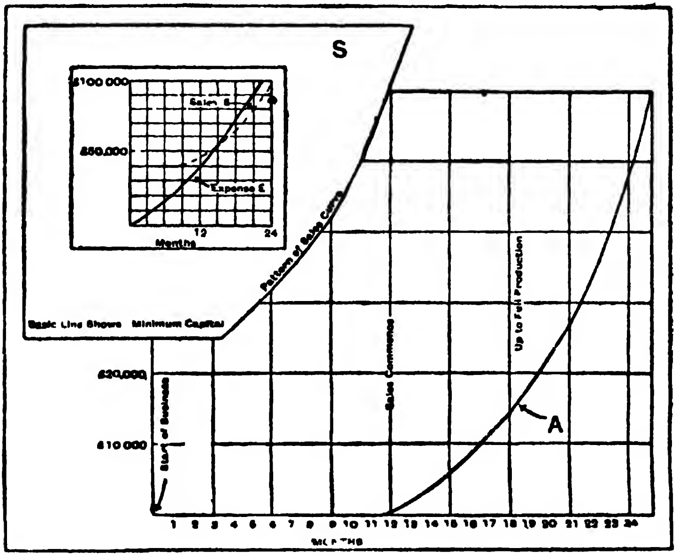
(*a*) Expense of flotation. (*b*) Factory charges (purchase, erection or alterations, rents, rates, etc.). (*c*) Plant and equipment. (*d*) Tools and experimental. (*e*) Starting up and running expenses of every description. (*f*) Stores purchases of every kind up to and including full production schedule. (*g*) Wage charges of every character (salaries, and all productive and non-productive labour). (*h-y*) Every other conceivable expense (and you will find plenty). (*z*) Cushion capital as a reserve.

The whole of the estimates thus developed were shown graphically in chart form similar to illustration on p. 65. This chart is a combination of the expenditure estimates and the time programme. It shows the total expense from the commencement of the proposition to the various periods as mapped out. Each item of expense being super-imposed on the others develops a "total expense curve" as shown at E. To avoid confusion in the subsequent figures the total expense curve E will only be shown. In actual fact, the curves by no means follow the easy curving lines as shown, but rise in jerks at various periods, as may naturally be expected.

The "gross sales curve" was developed in a similar manner, being also in combination with the time schedule, as shown at A in the illustration on p. 69. A paper pattern was then cut of the curve, as shown at S. By combining the two curves E (in chart, p. 65) and the paper curve S (in chart, p. 69) the actual capital required becomes obvious. It is likely to be very different from your anticipation. Furthermore, the effects of delayed payments and production lagging behind schedule are distinctly shown.

The method of combining the two curves calls for some explanation. In the first place, the curve E

shows the expenses as incurred. If all charges are paid immediately they are incurred, then the curve is also an illustration of your actual disbursements. Where, however, payments are delayed (as in purchasing on monthly account), the disbursement curve would lag behind the expenses curve by the amount of credit taken.



The planned sales curve is shown at A on the large diagram, and the paper pattern at S. This pattern is used in the capital calculations. The small figure inset shows a case in which expenses are higher than sales; hence something is wrong with the business.

In the same way, if your sales are for spot cash the sales curve S would represent your cash receipts. Actually receipts lag behind according to the credit you give, and the curve is delayed by that time. It is essen-

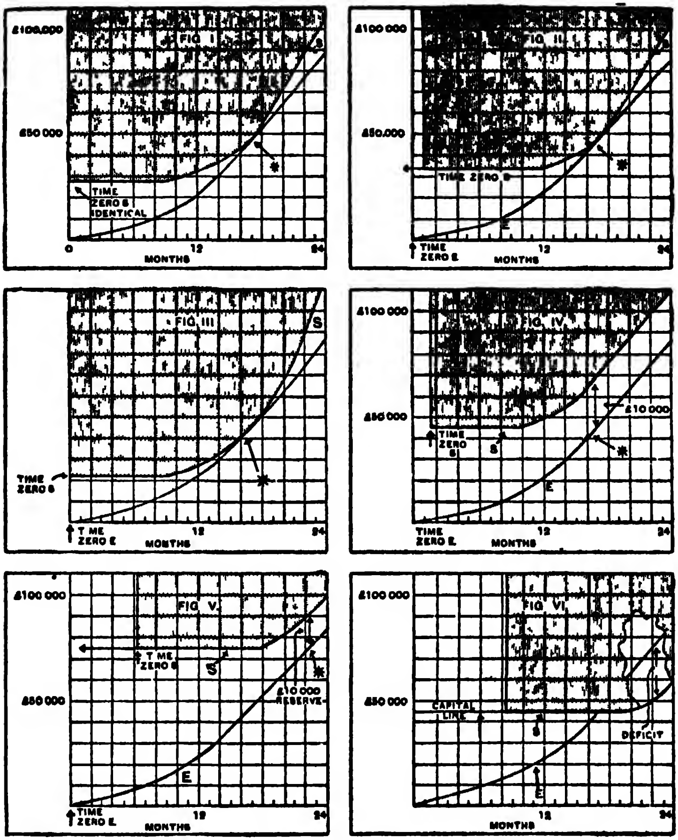
tial that this should be realised before full advantage can be taken of the facts shown by these curves.

Need I say that it is essential that the super-imposition of sales, curve S, on expenditure, curve E, should indicate a sharper rise on S than on E? Otherwise you are likely to manufacture at a loss, every week leaving you further in debt. If, therefore, the combination of the two curves is somewhat as shown in small chart inset in chart on p. 69, you need go no further. Either your costs are excessive or your sale prices too low. Where neither can be altered, the whole proposition is doomed from the start and can never hope to be successful.

Furthermore, unless the expense curve E includes such charges as depreciation, etc., the full allowance for these must exist in the increased rise of S over E, before this increase can be reckoned in the slightest way as an indication of the probable profits in the business.

It may here be mentioned that the curves as drawn allow for carrying a steady and equal stock. If the stock of work in progress is gradually built up, the actual results may show an increase of the expense curve without a corresponding increase of the sales curve. On the other hand, a gradual reduction of the stock will show an undue rise in the sales curve over the expense curve. This is merely mentioned to show that such curves must be considered intelligently and the factors governing them be fully realised.

Other combinations of the two curves are shown separately in charts on p. 71. In considering these curves it should be clearly borne in mind that they show an identical business, where expenses, purchases, and turnover are precisely the same. In spite of this a comparison between Figs. I. and VI. shows the very



Figs. I. to VI. show various cases of a business under different conditions. The capital necessary—for the same business in each case—varies from £21,000 to £75,000. In which category does your business come?

decided difference in capital required under the two conditions of trading.

I know of no more graphical way than this to show the disastrous effect of overdue accounts on your own

credit; and I feel that one cannot too thoroughly study the factors operating in these five curves. Juggle with the figures as you please, ignore their evident message as you will, they yet represent the implacable forces that govern the business of to-day.

The combination of expense and sales is shown in Fig. I., where—

(*a*) Spot cash is paid for purchases. (*b*) Spot cash received for sales. (*c*) No finished stock carried. (*d*) No reserve capital.

Following on what has already been said, it is obvious in this instance that disbursements are identical with liabilities (or expenditure) and receipts with sales. Consequently, the time zero of the E curve is also identical with the zero for the S curve.

If, therefore, the S curve is arranged to touch the E curve, as at *, we get the minimum capital shown at the left, from the horizontal of the S curve, viz., £26,000.

In other words £26,000 will just carry the proposition under the conditions outlined above. It will leave you, however, with "No cash at Bank" in the seventeenth month (as marked at *, where the two curves touch).

The effect of giving credit is shown in Fig. II.:

(*a*) Spot cash paid for purchases. (*b*) Monthly credit allowed for sales. (*c*) No finished stock carried. (*d*) No reserve capital.

Even if your monthly accounts are paid promptly, you will generally have owing about six weeks to two months' sales. The time zero for curve S must therefore be moved on by this amount. Allowing for the bulge of the S curve still to touch E, as at *, your curve S is compelled to rise, indicating under these conditions a necessary capital of £35,000.

The alternative effect of taking credit is shown in Fig. III.:

(*a*) Monthly credit taken for purchases. (*b*) Spot cash received for sales. (*c*) No finished stock. (*d*) No reserve capital.

Here we get the exact opposite of Fig. II., where now the time zero of your disbursements is six to eight weeks behind your cash receipts. Consequently the two curves are arranged as shown in Fig. III. Minimum capital, £21,000.

It should be noted that the critical financial period (marked *) shown at the fifteenth month, will actually develop two months later. This is owing to the time actually reckoning from the S time zero.

Fairly normal conditions are shown in Fig. IV.:

(*a*) Monthly credit taken for purchases. (*b*) Monthly credit allowed for sales. (*c*) Six weeks' finished stock carried. (*d*) £10,000 reserve capital carried.

Four factors here affect the position of the sales curve S. Taking the first two, they will be seen to neutralise each other so far as the relative positions of the time zeros are concerned. Consequently, but for condition (*c*), the time zeros would be identical. Condition (*c*), however, implies that you will have made six weeks' more work than you have sold, or, in other words, your sales curve S will be six weeks behind production. You thus get your time zero position for S.

Instead of allowing the two curves to touch at * as before, the condition (*d*) requires a £10,000 gap here, as reserve or "cushion" capital. Minimum capital required is in this instance £45,000. *Remember, it is just the same business as the* £21,000 *one in Fig. III.*

The effect of accumulating heavy stocks of finished

goods and extended credit to your debtors is shown in Fig. V.:

(*a*) Monthly credit taken for purchases. (*b*) Three months' credit allowed for sales. (*c*) Four months' finished stock on hand. (*d*) £10,000 reserve capital carried.

Here your S curve gets a bad throwback of six months, obtained thus:

Month's credit allowed	+	3
Month's stock carried	+	4
Total	=	7
Month's credit taken	−	1
		6 months.

The result is a necessary capital of £75,000. Compare this with the £21,000 shown in Fig. III. and the difference seems incredible. It is merely the difference between (1) starting a business on bare cost, and (2) financing it on long credit lines.

The probabilities are that a business would never carry all the four conditions enumerated, but an endeavour should be made to strike a medium between IV. and V. Furthermore, if it were compelled to work to conditions (*b*) and (*c*), then (*a*) and (*d*) would vanish, (*a*) being extended to two or three months likewise.

A scrutiny of any of the combined curves I have mentioned indicates in every instance a critical period during which the finances of the new business will of necessity touch low-water-mark. This point I have marked in each of the figures by a star (*). This will be the danger point to watch, and weeks before it arrives you will find yourself automatically anticipating the danger and taking steps to safeguard the position. After all, nine-tenths of the danger is removed when

foreseen and guarded against. The dangers we overlook, and which come suddenly upon us, are always the worst.

Fig. VI. shows the effect of your production programme being delayed. Compare this with IV., which shows the same capital of £45,000 with output to schedule. Instead of the critical period being passed with £10,000 in reserve and six weeks' stock on hand, the six months' delay in programme has turned this into a deficit of round about £20,000. When your curve shows the tendencies exhibited in this figure, it becomes an excellent whip to urge up production. The tendency shows itself weeks before it becomes critical, and you have an opportunity to get busy before the damage is done.

Thus far the curves have been treated as estimates. As the business develops they change from estimates to results. In their preparation you have gathered detailed lists which can be compared with your actual book-keeping figures. Granted, then, that the first estimates have been got out with reasonable care, it is *surprising how accurate* they eventually prove to be.

Where certain items exceed your estimates you see their effect on the whole proposition at once. You then have an immediate opportunity of making good in other directions and pull back what you have lost.

As the new business develops and the actual expenses are regularly plotted on your estimate charts, you gradually see the general tendency of the business unfolding. The charts and figures seem to develop a real personal entity, for they are the "voice of your business."

CHAPTER XI

Making Accurate Financial Forecasts

THERE is a company in London producing and selling a nationally known product. Three of its directors bear the same name as the firm itself. And in the minds of most people who see the list of the board, these three men represent the "brains of the concern."

There is another man on the board, whose name is unknown outside a limited circle, yet he carries out a most important function. He is not in control of any department of the company. He neither buys, produces, sells, advertises, nor controls accounting. He does not give orders to a staff of men or women; he has a quiet office of a non-executive character. His function is to study the financial condition of the business; look ahead for future requirements; analyse any new development under consideration by the company; and report on all these to his co-directors. If his reports are adopted, somebody else puts them into execution.

There is a man of this character in many large organisations. Sometimes he is called "comptroller of finance." Sometimes his function is merged into a more generally known title-of-office. Often he is just "one of our directors."

Now, the large organisation needs and can carry such a man. The small business cannot. In the small business, the "comptroller of finance" has to be the proprietor or managing director himself: but very often

he does not appreciate the full significance of that line of thought. Buying and producing, selling and advertising, accounting and recording, are the divisions of work usually recognised in business—controlling of finance is not realised as a separate function.

Yet it is a separate function, and at times the proprietor or chief of a business ought to split himself into the mental attitude of a "comptroller," and concentrate on that work as a definite and essential part of successful trading.

A "comptroller" studies two aspects of his firm: 1. The present in relation to the past. 2. The future.

When the symptoms of "slump" came to an unmistakable head in the early autumn of 1920, the head of a London business pushed aside every other claim on his time, and concentrated on finance alone. His first action was to have the profit and loss account for the preceding twelve months analysed on the expenses side into *percentages of the total expense*, and similarly with the profit and loss accounts for 1919, 1918, and *1913*. He wanted to see his present expenses side by side with those of a "normal" pre-war year.

Items of general overhead such as rent, rates and taxes, lighting and heating, insurance, auditor's fee, etc., of course came out for 1920 far lower in *percentage of total expense* than for 1913. On the other hand, the items of salaries and wages, stationery and office sundries, printing and advertising, and postages and telegrams, had mounted steadily during the war and after, until they had become far higher in percentage. It was clear from the percentage table that, if the business were to survive the coming storm, *all these must be cut.*

The expenses under these heads were then subdivided under departments of the firm, and again com-

pared with similar percentages for 1913. In salaries, for instance, the departments varied from a 100 per cent. increase (in percentage) to as much as 300 per cent. increase (in percentage). Or, in other words, the cost of the labour of men and women was approximately double the pre-war rate, but some departments had so expanded in personnel and in "big posts," that they were hugely out of proportion to 1913. (Let it be remembered that the comparisons were not on actual expense figures, but on percentages of the total expense—a perfectly fair comparison.)

These figures were "red danger signals." As the head of the firm saw it, having regard to the interests of his shareholders as well as his personal interests, the unwieldy items must absolutely be "axed," whatever might be the *desirability* of continuing them.

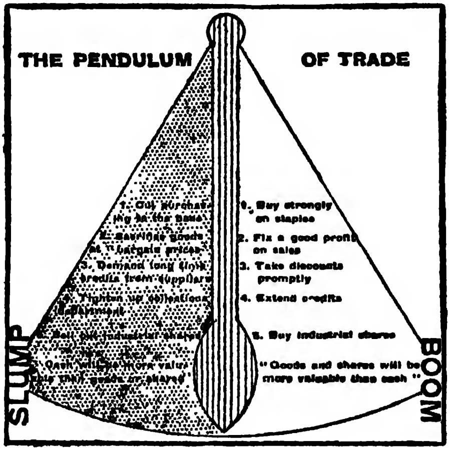
Similarly with stationery and office sundries, printing and advertising, and postages and telegrams. These were all dissected up into detailed percentages, under departments as far as possible, and compared with 1913. And the items which had become "bloated" were cut to the bone.

Take the case of stationery and postages, for instance. It was the custom of this firm to send many circular letters to their customers, on expensive stationery, and at letter-rate postage. The rate was cut to printed-rate matter on a series of tests. It answered. It was continued.

The expense side of the business having thus been brought under control, it was possible to estimate it for the coming year at a moderate figure. But this was not the only problem. An estimate of sales under the coming slump-time conditions made it clear that, even with the big reduction in the costs of running the business, there would be a loss to face on the trading of the

coming twelve months. And how was that loss to be financed?

The answer was the same as that in the case of tens of thousands of other businesses—some simultaneously the majority later:



No man in business can afford to ignore the pendulum of trade. Complete "swings" are rare, but the small movements must be continually noted.

1. Cut purchasing to the bone. Buy only from hand to mouth
2. Sacrifice goods at "bargain prices."
3. Demand extra time-credits from suppliers.
4. Tighten up the collections department.
5. Sell out immediately every type of share owned personally or by the business. "Cash is going to be more valuable than any goods or shares."

The above fairly represents the attitude of a "comptroller of finance" in a time of coming slump.

On the other hand, when there is clear sunshine overhead, and a period of increasing business confidence and rising prices of raw materials and finished goods, he reverses his attitude of mind. (A man of this calibre

never hesitates to trim his mind to the current of outside events.)

As an instance, here was the attitude of another man, in charge of a small business, at a time of rapidly increasing trade. He said to himself: "Goods are going to be more valuable than money. Now what do we learn from that?" And his conclusions were:

1. Buy strongly on staple goods. Even if we cannot pass them all on to our own customers we can find markets for them in big lots, at a moderate rate of profit, among the exporters. Do not let us be influenced in our buying by the exact price or shade of discount on the goods. If they are staple goods and not fancy articles liable to sudden shifts of public taste, then they are "a good buy."
2. Fix a good profit on sales.
3. Instead of attempting to run long credits with suppliers, let us "take our discounts" promptly.
4. In dealing with our customers, allow long credits without discounts.
5. Put our personal surplus money into industrial shares of companies which we know will stand to benefit by the rising tide of trade.

And in the case of a large business, he would have added:

6. If the public are ever likely to buy shares in our business, now is the time to offer them.

Every experienced business man will agree with the logic of the deductions from the above two opposite cases; but they are *extreme cases*, the opposite swings of the pendulum of trade. Usually, the man who puts himself into the position of a "comptroller of finance" is not nearly so sure of the trend of coming events. He cannot be a whole-hearted "bull" or "bear" of coming trading conditions. But at least he can do this. He can decide which of the two pictures is *probably* the true one, and cautiously trim his sails in that direction without mentally anchoring himself to the line of policy for a long period. Whichever policy he believes to be the true one, the deductions set out above will be the trend for his finance to take.

CHAPTER XII

Budgeting Ahead to Meet Financial Needs

FORECASTING general business conditions and adapting financial policies to fit, as described in previous chapters, is by no means the whole of a "finance comptroller's" functions. He must be ready to face his day-to-day financial needs also; he has to prepare his estimates of revenue, expense and finance for the coming three, six, or twelve months; with this he must correlate the other factors of the business—purchases, sales, outgoings, and commitments.

To deal with this problem efficiently requires that a business must operate to a greater or less extent on a budget system. The task approximates in nature, though not in degree, to that of a Chancellor of the Exchequer in forming his budget, except that whereas a Government usually starts with its necessary expenditure based on the checking up of departmental reports and requirements, and then finds the income from taxes to meet such expenditure—in a business, on the other hand, the budget usually begins with the possible sales or earnings that can be anticipated, and then adjusts the expenditures and costs and purchases to fit under the anticipated earnings. In a large organisation such a budget scheme is of course a complicated task. In the case of a small firm the details are not so elaborate, but the same general principles hold good.

What are the *key* figures of a business? Correct

book-keeping is quite a different thing from keeping a grip on the significant figures of a business. The accounts may be right as the book-keeper presents them, but that does not necessarily mean that they carry any significance as to tendencies.

In broad outline, what the man who controls finance must know is: On the "income" side—the sale figures; the accounts and bills receivable; the stocks in hand, whether raw material, semi-finished goods, or saleable goods.

On the "outgo" side—purchases; accounts and bills payable; average running cash expenditures; forward contracts and commitments.

Let us take as illustration a particular retail business, well established and therefore with past records to draw upon.

The first estimate to be made is sales. These should be charted for previous years so that the seasonal variations will be known.

The typical monthly sales for this business are shown in chart on p. 83.

The "seasonal variations" of this particular case are due to:

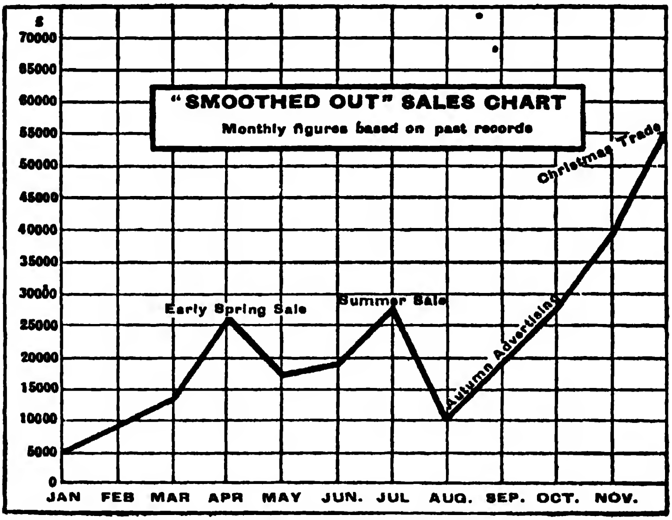
1. A very slack time in January. 2. A "bargain sale" in the early spring. 3. A "summer sale." 4. Extensive advertising in the autumn, beginning with September. 5. A very large Christmas trade.

Now, suppose it is believed that trade conditions will favour increased sales, and that strong efforts should be made to get a total increase of turnover on the year of 25 per cent. If the same general style of trading and the same fixed dates for "sales" are adhered to, then it is logical to "set a target" 25 per cent. higher for each month than the line in chart on p. 83 (One might make an exception with January, an extremely

slack month in this particular business. It might not be practicable to increase sales in January.)

This line of thought would give us the chart on p. 85.

Of course, such a chart would vary in outline with almost every individual business. And in the case of a departmental store, separate charts would be needed for the various departments, because they would not all have the same seasonal variations.



This chart, a typical monthly sales curve of a retail business, illustrates the method of estimating future business.

Having set a target for sales which is agreed to by various members of the firm as practicable, the next step is to *study the consequences* of it on:

1. Expenses. 2. Financing.

Which expenses will be higher during the coming twelve months?

The standing charges, such as rent, rates and taxes,

heating and lighting, insurance, auditor's fees, etc., will not be affected by an increased trading. The chief directions of increased expense will resolve themselves into:

(*a*) Salaries and wages. (*b*) Bonuses. (*c*) Stationery and office sundries. (*d*) Postages and telegrams. (*e*) Packing and dispatch. (*f*) Bad debts. (*g*) Wastages. (*h*) Miscellaneous sundries. (*j*) Unknown contingencies. (*k*) Printing and all forms of advertising.

"Salaries and wages" should not be greatly higher, because the men and women in executive posts will be expected to carry the increased executive work. For the extra routine work there will be needed some more assistants, clerks, and packers.

"Bonuses" should be based on the net profit of the year's trading, *after* all the figures are known. So this item will not arise in the estimate.

C, *d*, *e*, *f*, *g*, *h*, and *j* will all be higher.

"Printing and all forms of advertising" will necessarily be far higher, because the increased turnover is to be brought about mainly by increased advertising.

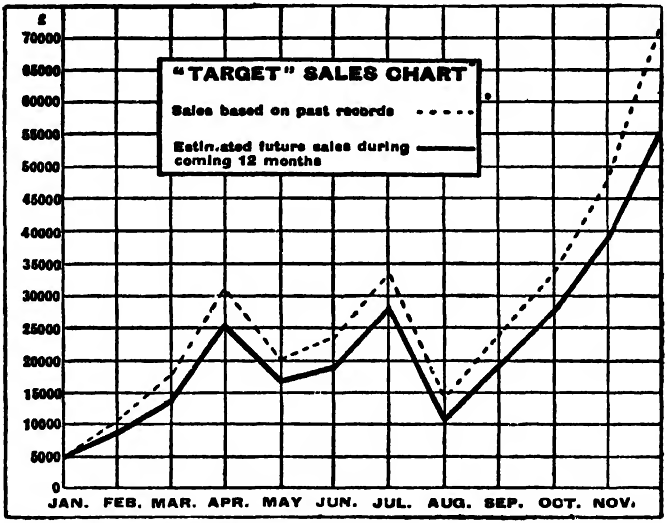
How much is to be allocated to each item?

This will be judged by first considering the extra turnover and the probable gross profit to be derived from it. The usual "marking" of goods shows 33⅓ per cent. on the selling price. Some goods carry up to 40 per cent. On the other hand, during the "sales" certain lines have to be marked down to 25 per cent. or less. The average gross profit shown by past records is 31 per cent. A gross profit of 31 per cent. on an extra turnover of £65,500 equals £20,300.

The percentage of expenses to turnover in past years has been about 26 per cent. But this includes the standing charges and the salaries and wages of the existing staff, which will not come out of the extra

gross profit of £20,300. It is therefore reasonable to fix the "expenses target" at not more than 22 per cent. of the extra turnover, or £14,400. We ought to be able to secure and handle the new trade at an expense of £14,400 or under.

So we hold a "round-table conference" with department hands, and make an estimated allocation of:



This chart gives a "target" based on the chart on page 83, to which the organisation may work.

		£
(a)	Salaries and wages	2,000
(b)	Bonuses (to be determined after the results of the year's trading)	——
(c)	Stationery and office sundries	250
(d)	Postages and telegrams	250
(e)	Packing and dispatch	1,000
(f)	Bad debts	250
(g)	Wastages	250
(h)	Miscellaneous sundries	250
(i)	Unknown contingencies	500
(k)	Printing and all forms of advertising ...	9,650

(or 14¾ per cent. of extra turnover)

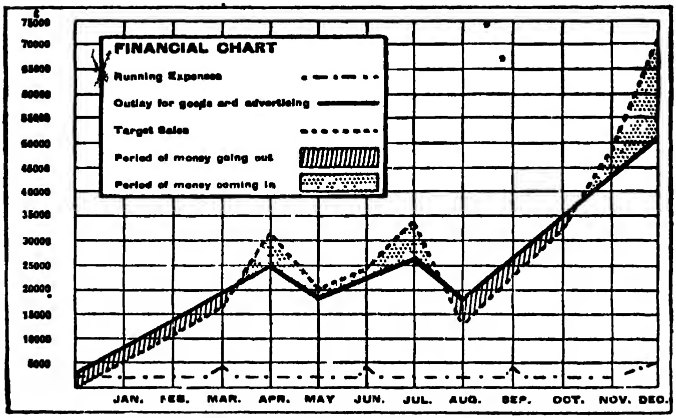
These figures are then passed on to the heads of departments for their guidance during the coming twelve months. The main figure is, of course, the appropriation to the advertising department of £9,650 over and beyond its ordinary allocation. And it should be made clear to this department that the figure must include anything and everything connected with sales promotion—press advertisements; posters; tram and 'bus cards; all forms of circularising; extra window displays; signs; and especially any form of "Give-away"—the extra special inducements by which trade is sometimes coaxed. (If the latter is passed by the advertising manager on to the sales departments, it will mean at the end of the year a "hole in the profits" for which no one is directly responsible.) It is then up to the advertising manager to prepare and submit a detailed estimate of how he proposes to utilise this extra £9,650, together with his normal allocation, during the coming twelve months.

When all these figures have been agreed, and the plans are put into operation, the "comptroller of finance"—probably the head of the business—will arrange to have weekly or monthly figures put before him showing how actual sales results compare with the target (chart on p. 85), and also how each of the items of extra expense compares with the estimated figures.

They will never tally exactly. They may be more favourable. They may be less favourable. In the latter case, it means that in a few months' time the whole of the estimates must be studied afresh and revised in accordance with the "trend of things." No estimate is sacrosanct. It is to be considered only as guidance for all concerned—a general course to be steered.

The "comptroller" then turns to finance require-

ments for the coming twelve months. A glance at the chart on p. 83 will make it clear that the requirements will vary very greatly in different periods of the year. The months of January, February and March will obviously be a period of loss for the business, when revenue will not cover expenses. August will also be a losing month. April and July will bring in money by reason of the "sales," but not at a high rate of



By the careful plotting of the curves in this financial chart, periods of difficulty and easy financing may be, to a large extent, forecasted. The difficult periods may then be watched and reduced.

profit. The steady profit of the business will be made in the months of May, June, and especially October, November and December. This applies in general to many businesses with heavy "seasonal variations": in some months they are definitely losing money, in others making correspondingly high profits.

On the basis of previous figures we can construct the financial chart on this page.

Coming outlay will be classed under three heads :

1. *Running expenses—staff and general overhead.*

11 per cent. of £261,250	...	...	... £28,737
$7\frac{1}{2}$ per cent. of £65,500	...	...	... 4,749
			£33,486

This means a monthly outlay of approximately £2,800, fairly even throughout the year, except for the quarterly rent and taxes payments and the extra staff needed for the Christmas trade. It is r chart on p. 87 by a dot-and-dash line ru the page.

2. *Printing and advertising expenses.*

15 per cent. of £261,250	...	...
$14\frac{3}{4}$ per cent. of £65,500	...	...

3. *Buyings of new stock.*

Total turnover of £326,750 minus 31 per cent

Combining 2 and 3 we get £274,4(represented in chart on p. 87 by a sing super-imposed seasonally on the dot-and the running expenses. Of course the buy and the ordering of advertising matter advance of actual sales, but the dates of goods and advertising expenses can be they usually are—to come near to the dates will be pouring into the business.

The portions of the chart on p. 87 sh will represent the periods of more mon than coming in; and the parts tinted in c the periods of the reverse.

It is then the duty of the chief of the c to adjust his outgoing payments for goo tising expenses so that the portions of the in lines become as small as possible.

CHAPTER XIII

Supervising the Day-by-Day Financing of a Business

By T. FRAME MILLER, F.C.A.

IN preceding chapters others have presented the methods for making financial forecasts in order to determine the broad policies of business finance; also the plans on which to lay out the finance of a business three, six or twelve months ahead; now, finally, must come a consideration of how to deal systematically and accurately and soundly with the day-by-day financing of a business.

First it may be laid down that this day-by-day financing cannot be safe and sure unless the previous general forecasting and planning in advance has been carried out. Primarily, the one purpose of a financing plan is to meet the firm's obligations when they come due, and have a little left over besides. In order to do this, two things are necessary: first, that the financial manager shall know what his future obligations are, in amount and in due dates; second, what his resources are, again in amount and dates realisable.

A medium-size firm which manufactures its goods and sells them both at wholesale and retail, so that it has a variegated problem to meet, has its financial situation always laid out three months in advance. The items are divided into the "commitments" side and the "income" side. On the commitments side there is listed:

First, the bills payable, which are almost invariably known three months in advance.

Next, the accounts payable, which are definitely known at least one month in advance, and can be quite accurately estimated for the other two months in advance.

The salary and wages pay-roll, which can be calculated ahead almost to a penny.

The fixed expense, which can also be accurately estimated, such as rent, insurance.

The current running expenses, all the way from petty cash items and postage up to larger items, for all of which the past records of a business will allow an accurate estimate.

Then come items which have to be specially considered, such as orders which have been placed but not yet invoiced, large purchases of material which are anticipated, any extraordinary out-goings such as reduction of a bank overdraft or equipment of a new department, etc.

Finally, a certain amount for contingencies.

On the income side the items consist of:

Money in hand and at call.

Bills receivable on fixed dates.

Accounts receivable, tabulated as to dates on which payment is expected in accordance with past experience.

Estimated cash sales.

Estimated new sales that will result in payments during the period in question.

Anticipated realisation of any stocks or other assets.

In a business which has a long past to go upon it is much easier to be accurate in the forecasts of expenditure than of income, for debts that one is planning to pay can be more definitely fixed than debts that somebody else is going to pay us. On the income side the chief emphasis must be placed upon an accurate tabulation of what may be expected in the way of collecting accounts receivable, and this is again a matter of careful analysis of past records. While these estimates are laid out three months in advance, at the beginning of each month when a new third month has to be added it is always necessary to revise the two immediately succeeding months on the basis of the newer facts in hand.

A business man who has not tried this scheme will

Month.	*Cash in Hand.*	*Cash at Bank.*	*Bills Receivable.*	*Anticipated Receipts from Sundry Debtors.*	*Running Total.*	*Bills Payable.*	*Sundry Creditors to be Paid.*	*Running Expenses.*	*Running Total.*	*Balance.*
	£ s. d.	£ s. d.	£ s. d.	£ s. d.	£ s. d.	£ s. d.	£ s. d.	£ s. d.	£ s. d.	£ s. d.
October ...	52 12 6	330 19 0	Nil	1,872 19 6	2,256 11 0	350 0 0	1,836 12 5	420 16 4	2,607 8 9	350 17 9 Debit
Estimates for Nove			150 0 0	2,500 0 0	2,650 0 0	250 0 0	1,500 0 0	500 0 0	2 250 0 0	400 0 0 Credit
Estimates for December			Nil	3 500 0 0	3,500 0 0	400 0 0	1,500 0 0	500 0 0	2,400 0 0	1,100 0 0 Credit

be surprised how accurately in the course of time the calculations work out. The business which is using the above plan has anticipated its coming month's figures as closely as 2 per cent. of the actual, and even for a whole quarter in advance as closely as 5 per cent. of the final real figures.

A small business dealing in only one line of goods and with a more personal control of its affairs, has an even simpler tabulation, as shown on p. 91.

Here again, of course, the adjustments are made every month as the months move up to the top of the sheet.

It is at once evident that such an estimate as this is subject at times to drastic disappointment, but the longer one pursues a system of this kind the more accurate will one's forecasts become. The first rule in conducting such a scheme is to avoid optimism—to go strictly on the basis of past records and to calculate as much as possible on certainties. But even when there is a falling-off on the income side this need not be accepted without protest. And here is where one of the principal virtues of such a scheme arises. By keeping totals day by day as the month progresses of actual expenditure and income, as well as of purchase commitments and sales, it is always possible for the man controlling finances to see whether variations from the estimated figures are arising, and whether, therefore, he must take emergency steps. For instance, if accounts receivable are not collecting to the amounts estimated, extra pressure may have to be put upon getting in collections. The firm cited above has at times been compelled to offer special inducements to debtors in the way of extra discounts or favours in order to get money in for contingencies. If a permanent

downward tendency becomes evident it may even prove necessary to shorten the terms of granting credit so as to

FORECAST

ISSUED Dec. 31st 1921,

	Jan.	Feb.	Mar.	Apl.
1. Net income from Sales	—	—	—	—
2. Quantities of Material Solt	—	—	—	—
3. Quantities of Material Made	—	—	—	—
4. Prices, All Materials end of month	—	—	—	—
Current Assets	**Jan. 31**	**Feb. 28**	**Mar. 31**	**Apl. 30**
5. Total	—	—	—	—
6. Materials and Supplies	—	—	—	—
7. Product	—	—	—	—
8. Accounts Receivable	—	—	—	—
9. Cash	—	—	—	—
Current Liabilities				
10. Total	—	—	—	—
11. Bank Loans	—	—	—	—
12. Accounts Payable	—	—	—	—
13. Excess of Current Assets over Current Liabilities	—	—	—	—
14. Ratio of Current Assets to Current Liabilities	—	—	—	—
Receipts	**Jan.**	**Feb.**	**Mar.**	**Apl.**
15. Collections	—	—	—	—
16. Total Receipts	—	—	—	—
Disbursements				
17. Total	—	—	—	—
18. Materials and Supplies	—	—	—	—
19. Wages	—	—	—	—
20. General Administration & Overhead	—	—	—	—
21. Advertising and Selling	—	—	—	—
22. Interest	—	—	—	—
23. Taxes and Other Disbursements	—	—	—	—
24. Receipts over Disbursements	—	—	—	—
25. Net Profit	—	—	—	—

000 omitted

These twenty-five items are forecasted each month for the next four months by the methods described in this chapter.

bring the money in more promptly. On the other hand, unlooked-for expenditures sometimes arise which

have not been provided for in the tabulation of income; to offset this it may again be necessary to get in money more quickly or to apply to the bank in advance for accommodation.

Arranging Finance to Cope with Falling Sales

If it is seen that sales are falling below estimates, it means that either expense must be reduced proportionately, or financial arrangements made to meet the temporary slump. The figures may show that it is necessary to stop purchasing and reduce stocks, so as to liberate cash; or to sell any other assets in order to turn them into money. But whatever happens the business man with such a detailed forecast before him is always sure of his ground and is able to take time by the forelock in meeting the emergency. On p. 93 is another instance of a more elaborate scheme. At the end of each month an estimated balance-sheet for four months ahead is drawn up. First, sales are estimated; then with this as a basis, production—purchases—stock to be carried—wages. Likewise accounts receivable and collections are estimated; this firm finds that two-thirds of the sales of the present month plus one-half the sales of the preceding month plus one-third of the sales of the month before, make up the average accounts receivable at the end of any month; and collections for any month are naturally *vice versa*. A number of consistent tests to check the accuracy of this forecast can be made—for instance, the cash at the first of the month plus collections less disbursements during month must equal cash at end of month. These forecasts are always compared with actual results when known, so that the basic percentages on which the forecast is built can be kept accurate and thus enhance the accuracy of the forecast.

In some businesses this control over the day-by-day income and out-goings goes so far that the financial manager must approve of all purchases before they are made; this in order that he may definitely determine whether his financial prospects are such that he can pay for such purchases when they fall due, or at any rate that he may arrange such terms as may fall in with his capacity to pay. Purchases must often be regulated by ability to pay. It is better to purchase in small lots and sacrifice slight market advantages, than purchase in big lots and run the risk of money pinch. Likewise, it is even better to refuse to make a sale on long credit terms if it ties up an amount of money which will throw out of gear the financial scheme of a business. To match approaching obligations against resources, to foresee demands and provide for them, to meet commitments strictly on maturity without undue anxiety—these are the purposes of a scheme of this kind.

It should be added that the virtues of such schemes, once they are in working operation, are felt far beyond the financial department of a business. Such a plan is really a small budget system in itself, and helps to keep the business running soundly and at a profit. For if a certain item of expense arises far beyond the estimate, if a purchase is made or expenditure incurred that has not been provided for, if income falls below anticipations, the natural next step is to find out why and to remedy the cause. That is why the man who manages the day-by-day finances of a business gradually comes to be an expense controller and a profit-maker, for by constantly watching expense and income as well as purchases, he gradually comes to control them and to hold them in line with requirements.

CHAPTER XIV

The Principles of Giving Credit

THE extent of the giving of credit naturally depends on:

1. "The custom of the trade."
2. The amount of capital one has available, because giving credit means, in effect, lending money to customers.
3. The general business conditions at the time when credit is asked for.

The terms offered to wholesalers or to retailers will, of course, be governed by the customary conditions of the particular trade. Such customs are stubborn, because the wholesaler or retailer is used to running his business on these terms; has adjusted his methods of finance to them; has trained his counting-house on these lines; and would be "put out" by any suggested shortening of credit, or by "pinching" the rate of discount he is accustomed to receive for cash payments.

The length of credit which a retailer should extend to his customers will vary very greatly with the trade and with the clientèle he serves. It is an individual problem.

It is usually laid down that the amount of credit given should not exceed one-third of the working capital.

There would, of course, be "seasonal variations" in the amount of credit—lighter in the slack times, heavier during the rush times. But the average credit given per month should be kept down to a figure not

exceeding one-third of the working capital; and to provide comfortably for the extra credit strain during the period of rush selling, it is always advisable to arrange beforehand for longer credit from one's suppliers to cover the financing of that period.

Of course, the above may sound an ultra-conservative method of doing business, especially in times when "things are looking rosy." But since every boom-time in business has been followed, and will be followed, by a slump period, and since very few people are able to foresee just when this slump will set in, the wisdom of trading conservatively reaps its fruit over the period of a complete "trading cycle."

Credit restriction is really a form of insurance against heavy bad debts at a time of sudden slump—debts which might wipe out the whole of a year's profit.

And further, the owner of a factory or of a distributing business must determine whether he proposes to act *as a trader or as a banker*. There are profits in either, but it is necessary to draw a clear distinction between the two.

A factory extending long credits is lending goods—in effect, lending money—to its customers for months at a time. It may be a proper course to pursue, but this part of its activities is essentially of a "banking" nature; and the logical consequence is that the factory must arrange ahead for sufficient financial backing and accommodation to enable it to "carry on"—buy raw material, pay all running expenses of factory, and running expenses of selling and distribution—as well as to cover the long credits it is extending to customers, and to provide against the dangers of a sudden slump.

Otherwise it is liable to be caught "over-trading"—the downfall of many a business sound in other respects.

At a time of general slack trade, when selling competition is acute, and the buyer is "in the saddle," a manufacturer or merchant naturally has to be more elastic in respect of extending credit.

Credit, however, should not be allowed to go beyond the bounds of the percentage set for one's business.

The usual sources of credit information on customers are:

(1) Trade references. (2) Bank references. (3) Through a Trade Protection Agency.

The first two are the ordinary and usual methods of obtaining credit information; the third is often not utilised to the extent it deserves.

The Mercantile Agency and its Methods of Obtaining Information

A Mercantile Agency serves a highly useful purpose. One of these gathers information from the whole of the U.K., through a couple of hundred representatives in the large cities, constantly going around and securing information, and through more than 25,000 "correspondents" covering the smaller towns and villages. These correspondents may be lawyers, accountants, "bank agents" (in Scotland), or other people in close touch with the business life of their community.

The information it obtains from the business man himself is regarded only as a means of obtaining clues to other directions of enquiry. The main line is to seek out suppliers and wholesale houses from whom the business man buys; then to go to these firms and find out by personal investigation whether he has duly paid his bills in the past, and what line of credit is being extended to him in the present. Such an agency

sets out to gather the very kind of information which a business man himself would want to obtain before extending credit, but usually has not the time and the facilities for doing so. It acts as a clearing house for information of all kinds affecting the solvency and credit of a business man. (The Trade Protection Agency can also be used to valuable purpose for collecting debts. This will be referred to again in a later chapter dealing with methods of getting in overdue accounts.)

It is entirely in the interest of general business soundness and confidence, that every honest business should give clear and full answers to the representative of a Trade Protection Agency. Over in the States they go further. They cross-examine. They ask the business man to *sign* the statement he makes. And if he refuses to sign, it is so noted in the reports of the Credit Agency, and means a black mark against him.

On the basis of such reports, the credit manager (or whoever corresponds to him in function) draws his conclusions as to the ability of the customer to sell the goods wanted; the probability of the customer paying for them at the due date; and the "moral risk" involved.

Naturally this needs and requires considerable experience as well as business judgment. A man who has never borne the burden of a period of trade slump, and directly felt, personally, the effects of it, is not the man to pass on credits. Experience of how various types of business men react towards the payment of debts, and experience of the difficulties of collecting accounts in times of business stress, are absolutely necessary.

Nor is it advisable that the functions of a credit manager should be included in the functions of a sales manager. The latter is primarily concerned with making sales. The volume of business he places on the firm's books is to him the index of his ability—and most sales managers feel that, having made sales, it is then up to the counting-house to get the money in.

The Restriction of Bad Debts to a Minimum

On the other hand, the credit manager looks primarily to keeping bad debts down to a minimum. He does not view large orders with the same enthusiastic attitude as the sales manager or the traveller—particularly the traveller. He wants to sell goods only where he is almost completely sure that they will be paid for, and paid for at the proper time.

In using the term "credit man" we of course mean any person in the business who carries out this function. It may be the owner of the business himself. If it is, it means that in deciding on credits he has to dissociate himself from his other functions, and particularly from his function of *selling*, so as to maintain a prudent point of view towards the business risks of giving credit.

An able credit manager keeps highly detailed card records of customers, revised up-to-date every six months or so by reports secured from other suppliers in the trade, or from a Trade Protection Agency.

It is important that the customer shall not exceed the line of credit allowed to him; and it is also important to find out, if possible, what his commitments are to other suppliers, so as to make sure he is not "over-trading." In many lines of business, manufacturers and wholesalers exchange such informa-

tion through a Mutual Protection Association. And similarly, in retailing, the departmental stores have a regular system of circulating credit information about their clientèle for mutual protection.

The ready accessibility and completeness of card records is valuable in case of a customer coming personally to the showrooms and starting to select a line of goods. The assistant serving him may not know as to how far credit should be extended; and in the possible absence of the credit manager, the card records should be such as to provide this information, at a glance, to any other member of the firm who may need it.

Retail "Sanction" System

In the case of a retail shop, it is sometimes even more vitally necessary to get credit information on a customer very quickly—as well as very discreetly. There are several methods of ensuring this; but the best is carried out in the following way:

The counting-house have the names of credit customers and their standing typed on narrow slips of cards, which are inserted into metal holders corresponding to the leaves of a very large book. These leaves are mounted vertically on a stand, so that they can be flipped over in a moment when the name of the customer is being sought for.

The "sanction" department is connected with the various departments of the store by telephone. The assistant at the counter sends up his enquiry through a telephone away from the customer's hearing, and at the same time places the customer's bill in a slot attached to the apparatus. When the "sanction" department have looked up the customer's name, and decided that he or she is "good" for the amount in

question, they press an electric switch, which stamps a "sanction mark" on the customer's bill down below. The whole operation may take half a minute or less. It is obviously far quicker than the sending up of messages by messenger boys; and it is so discreet that most customers are unaware of its existence.

It sometimes happens that an alert credit manager obtains information that a customer has a number of accounts falling due at a particular date—with the probability that some of the suppliers will be put off with excuses for delayed payments. And in such a case it is clearly advantageous to write and offer some concession in "terms," on condition that the account be paid before this dangerous date.

The credit man should therefore keep in close and friendly touch with the travellers of the firm, so as to obtain from them information or hints which will guide him in the fixing of credit limits, or in urging payment before customers become pressed in too many directions at once. It is advisable, too, for the credit man occasionally to step outside his office and go to visit some of the customers about whom he feels doubtful, in order to obtain first-hand impressions which may be of very considerable value to his house.

CHAPTER XV

Getting Debtors to Pay

WHAT proportion of book debts can one expect to collect?

Early in 1920 the writer had the privilege of examining the counting-house figures of various retail and manufacturing businesses. One firm was collecting 99·85 per cent. of the debts due to it. Others varied between this figure and 99·5 per cent.

It must be remembered that this was at a time of general (even if artificial) prosperity, when everybody seemed to have plenty of money and therefore were *able* to pay their debts. During the "slump" period such collections averages became very unsatisfactory. Large numbers of people were *not* able to pay, even if they had the will to do so; and further, a considerable proportion of the business world became "only as honest as they could afford to be." This is typical of all slump periods. But when trading conditions are reasonably good, an efficiently managed counting-house should certainly be able to collect 99·5 per cent. of its book debts, and in many cases the target can be set at 99·8 per cent.

Let us try to analyse the "debtor frame of mind."

At the one end of the scale there is the firm who is positively dishonest. They set up a small office with about £10 worth of fifth-hand furniture; or they rent a vacant shop on a week-to-week basis and furnish it

with a few boardings for counters; they have a letter-heading pulled up by a jobbing printer; and they then write letters broadcast to manufacturers, wholesalers, or manufacturers' agents, asking for a consignment of goods, and painting glowing prospects of sales in their particular locality.

This type of firm will *promise anything* to get goods sent to them. The one thing they will not do is to pay cash in advance, or cash on delivery.

Men running this type of concern seem to go on year after year, setting up their offices or shops in different localities, and obtaining goods from fresh sets of victims whom they persuade to believe in their honesty. When they get hold of the goods, they sell them at cost price from their shop, or through house-to-house canvassers, or from stalls in country market-places.

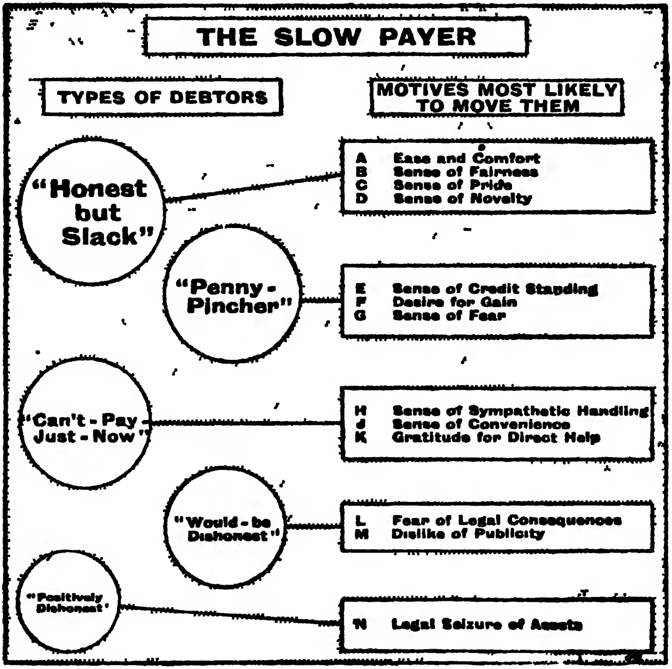
Debts due from these people will never be collected, and the only way to avoid such bad debts is to ask for and take up trading references, or secure a report from a mercantile agency, and to turn down the suggested orders if there is the least hint that you are about to deal with that class of "fly-by-night."

Classes of Debtors and their Characteristics

Apart from the positively dishonest, who of course form a very small part of the population, there are a larger number of would-be dishonest people who would be dishonest if it were made easy for them, and if they felt they were not thereby incurring legal risks. This is the class of people whom the counting-house has to watch for. They may pop up in any direction. They are ready to take advantage of any "easiness" on the part of the creditor. The thing they *do* respond to is firmness in asking for payment of debts, punctuality in

demanding payment, and energetic methods of "following-up."

Then there is the class of debtor who is perfectly honest, and without any intention of avoiding or



All debtors fall under one or other of the classifications shown on the left, and can be relied upon to respond pretty regularly to the treatment detailed to the right.

evading his obligations, but simply has not the cash to pay at the time the debt falls due. Let us call him the "can't-pay-just-now."

Another very large class avoid punctual payments for the reason that by delaying them they obtain a business

advantage—the use of that money for a few weeks, or perhaps even for a few days, longer than agreed upon. These men do not consider themselves dishonest, but merely "business-like." They are "penny-pinchers."

And finally, there is a much larger class of debtor who is "honest but slack." He has no definite intention of evading his debts, but has a constitutional habit of putting off payments, failing to answer letters, and generally "dragging out things," until he is actually compelled to pay.

In view of the variety of classes of debtors, it is clearly important to have not only a general set of letters applicable to debtors *en masse*, but further, to try to "place" the psychology of the man, and write to him individual letters which will fit in with his individual habit-of-mind. The firms who have carried the matter of making collections to a fine art are always on the look-out for any indication or hint from their past dealings with the customer, or from his correspondence, or from reports made by travellers, as to which of these broad divisions of debtors he belongs. Whether he is to be treated as:

"Honest but slack."
A "penny-pincher."
A "can't-pay-just-now."
"Would-be dishonest."
Or "positively dishonest."

Every counting-house manager ought to have a copy of that excellent little book entitled "How to Collect Money by Mail" (published by the A. W. Shaw Co., Ltd., at the price of 4s. 10d., post free). It goes into very great detail, and gives a large number of specimen letters which have proved successful for manufacturing, wholesale and retail businesses of all kinds.

In the constructing of a set of *general* collection letters, to be used in the ordinary course of routine, the London firm referred to above, who had a collection average in 1920 of 99·85 per cent., employ the following principles :

The Construction of a Set of General Collection Letters

Preliminary.—All price lists, invoices and statements have the terms of account printed on them very clearly and more prominently than is usual.

Letter 1.—Simple reminder. Statement of account sent on the 1st of the month with coloured gummed slip attached. This slip, however, is not the kind of thing one buys ready made at a stationer's—collection slips which are used by the million all over the country, and therefore have lost their sense of freshness. This firm has its own slips, worded and coloured in a manner individual to the house.

Letter 2.—15th of the month. Second reminder. with a different coloured slip attached. It will be noted that the firm first of all assumes that the debtor belongs to the class of "honest but slack."

Letter 3.—22nd of the month. Points out that no reply has been received to the two previous letters; suggests that these have been laid aside under pressure of business; and confidently assumes that on receiving this third reminder, the debtor will at once send a remittance.

Letter 4.—29th of the month. This letter is still courteous, but much firmer in tone; asks for immediate settlement; and by way of making it easy for the debtor to reply, draws special attention to the enclosure of a ready stamped and addressed *registered* envelope, in

which he is invited to send any form of remittance—cheque, Treasury notes, postal orders, or odd stamps to make up a total. The device enclosing a return *registered* envelope has been found to produce a strong psychological impression on the debtor; and is very effective.

Letter 5.—Seven days later. This letter is written on a special letter-heading of a very formal character, quite different from the usual illustrative and "friendly" letter-heading of the firm. It is stiff and restrained, and creates an immediate impression of "meaning business." After reminding the debtor that previous letters have been sent to him on the 1st, 15th, 22nd, and 29th, and that he has neither replied with a remittance nor given any reason for delaying payment, it states clearly and definitely that if a remittance is not received within seven days, the matter will be placed in the hands of the firm's solicitors.

Letter 6.—Seven days later. This letter is on the solicitor's note-heading. It states that John Smith and Co. have handed over to the solicitor certain accounts for collection. The solicitor understands that an account was opened with Mr. So-and-So on the clear agreement that he would pay by such-and-such a date, and in the belief that he was financially reliable. It therefore asks for an immediate settlement within three days.

Letter 7.—Three days later. Also on solicitor's letter-heading. Very short and extremely formal letter stating that unless remittance is received by return of post, legal action will be taken.

It will be seen from the above summary that these letters start with the assumption that the man is "honest but slack," and run roughly through the

various grades of debtor psychology, ending on the assumption that he is dishonest.

But the above series, effective though it is in general cases, gives way to special letters whenever there is an indication that the man definitely belongs to a special class of debtor. These letters are made to play upon his *individual* habit of mind. Let us try to probe deeper into these types of mind, and the methods which will persuade them towards paying up.

The "Honest but Slack"

This type of man can be moved to action by playing on several motives:

(*a*) *His Ease and Comfort.*—The ready stamped and addressed registered envelope makes it easy for him to reply. He is not likely to throw it away. These stout envelopes supplied by the Post Office have a solidity and impressiveness about them—they are rarely, if ever, thrown away; and they certainly make it very easy for the man who is too lazy to write out a cheque. He can slip into the envelope Treasury notes, postal orders, or oddments of stamps lying in his till or cash box, so as to make up the required total.

Another method, to be used in the case of large amounts, is the drawing of a "bill" on the man, which he is asked to accept by the simple process of signing his name.

(*b*) *His Sense of Fairness.*—Pointing out that the creditor has to pay his own bills promptly, and does so, and that it is only fair that the debtor shall do likewise. The creditor has based his very low prices on the terms clearly printed on the original price list and invoice, and cannot run his business without loss unless his customers keep to the agreed terms.

(*c*) *His Sense of Pride.*—A man-to-man appeal to him to "keep his word." This is a powerful weapon, and when it is used, one should be very careful to avoid conveying the impression that one thinks he is *trying to break* his word. Many a man who will respond to a plain appeal to his honour will take instant offence at a suggestion that he is dishonourable. It will rankle with him. Even if he pays up, he will not do business with you again.

(*d*) *His Sense of Novelty.*—"Stunts" very often answer with this type of man. For instance, a highly successful collection letter had a piece of string run through it, tied with a single loose hitch, and the customer was invited to tie it into a firm knot in order to remind himself to pay up promptly! Again, in the collection of small sums of money owing to a retailer, a metal disc was enclosed on which was printed "I MUST remember to pay Jones and Co.!" The customer was asked to put this in his pocket as a novel form of reminder, and hand it over the counter when paying his bill. It was found to appeal.

The "Penny-Pincher"

This type of man is not usually amenable to appeals to his sense of comfort, honour, or fairness; and he is not to be "tickled into action" by special stunts. He is deliberately keeping back payment in order to obtain the business advantage of a longer use of his money. Therefore the motive to move him must be a "business motive":

(*e*) *His Sense of Credit Standing.*—Impressing on him that an essential of business is to keep in good credit standing with one's suppliers—who are always ready to do a favour to a good customer, or to let him

have first information of any really special line, or to extend credit at a time when it is *vitally* needed. "It pays to pay promptly."

(*f*) *His Desire for Gain.*—Playing on the advantage of taking discounts, which so many of the leading retailers in his line are now doing.

(*g*) *His Sense of Fear.*—Curtness and an impression eping some reserve "club" in the background, ometimes move this type of man, who is liable to houghts which have no real foundation.

The "Can't-Pay-Just-Now"

This man may be hard pressed for cash to pay his various creditors. He may not be actually insolvent, but his business is customarily run in such a loose financial way that every now and again accounts pile up on him which he is unable to meet all at the same time. Or else he is suffering from an unexpected run of bad luck—local strikes affecting his trade; or family troubles; or personal illness; or some unforeseen business contingency which has "tied him into knots." This type of debtor needs *sympathy* plus firmness—and firmness which is not released; he must be led towards good business habits. An endeavour should be made to find out his trouble. Perhaps it will come in an answering letter, or through the medium of travellers' information. The motives which will move him to pay will most likely be:

(*h*) *His Sense of Sympathetic Handling.*—He is probably able to meet *some* of his debts in cash, and will respond to the firm which endeavours to enter into his feelings and gives him sympathy as well as a firm touch on the reins.

(*j*) *His Sense of Convenience.*—An offer to let him pay by easy instalments, in the form of bills at (say) one month or two months, so that he can have time to arrange his affairs and get money in from his own debtors by the dates these bills fall due.

(*k*) *His Gratitude for Direct Help.*—Some firms have successfully collected from a nearly-insolvent business debtor by having a member of the firm visit him to help in putting his affairs in order—increasing sales, moving slow-selling lines, tightening-up collections, and cutting out wastes and leakages.

The "Would-be Dishonest"

If one can definitely diagnose a man as such, then clearly it is waste of time to approach him from the angles of fairness, honour, business convenience, sympathy or gratitude. The only motives likely to move him are:

(*l*) *His Fear of Legal Consequences.*—These can be emphasised and rubbed in much more clearly and directly than with any other type of debtor. The trouble he will be put to by legal action, and the inevitable extra expense he will thereby incur, should be stated to him in uncompromising language.

(*m*) *His Dislike of Publicity.*—A man of this kind is afraid of other people knowing or suspecting what he really is. He can therefore be moved by the most open follow-up that the law allows. Dunning by postcard is illegal, as being damaging to reputation. But dunning by telephone, for instance, is effective in some cases. The debtor is inclined to suspect that some third party is listening-in and overhearing the conversation. He wants no publicity.

And it follows also that this class of debtor is a fit subject for the debt collection agency, or the mercantile agency which makes a speciality of a department for the collection of debts.

The "Positively Dishonest"

Words will not move this man. Action—and *swift* action—is the only method of collecting from him.

(*n*) *Legal Seizure of His Assets.*—A successful judgment summons should be followed up *instantly* by garnisheeing his bank account—provided he has one—or by legal seizure of any other of his possessions. If he has left his address "for parts unknown," which is usually the case after a judgment summons, all the mercantile agencies should be notified, as well as the firms of suppliers in one's own line of business. It may not actually lead to securing the money due from him, but at least it will help to prevent him playing the same game in another town, and perhaps discourage others from following his methods of business.

Letter-writing is useless for this man, but with all the other classes of debtors it is perfectly possible to collect by post. Some firms find that it pays them to call in an outside expert to devise for them sets of debt-collecting letters, in order to have those difficult letters as compelling and effective as possible.

CHAPTER XVI

System in Collecting Accounts

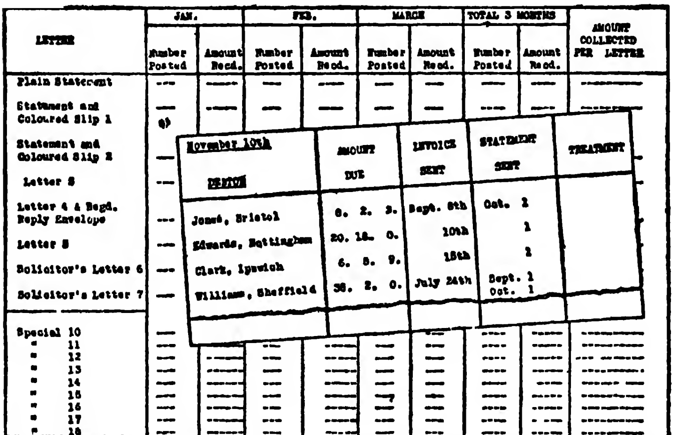
ANYONE who has had to examine into a small business on the verge of insolvency, will probably have found that system in collecting accounts was either non-existent or extremely loose and irregular.

You are referred to the pages of the ledger (or the ledger cards) for particulars of debts owing, and to pick these out and arrange them systematically is a lengthy task. It is quite evident that the owner of the business must have kept himself ill posted on debts which were owing, and how long they were overdue, and the standing and habit-of-mind of the debtors who owed those sums of money. Perhaps he left the matter of collections to a routine counting-house clerk, only digging into the matter spasmodically when an urgent need for cash forced him to attend to this uncongenial function of his business.

At the opposite end of the scale is the firm—and there are many of them—who have highly perfected systems of watching-out for " slow " debtors and inducing them to pay up. One such wholesale house makes a survey every tenth of the month. On this day the chief bookkeeper has to place before the head of the firm a summarised list of debtors (Form 1, p. 115).

The names of the customers and their general behaviour as debtors will probably be so well known to the head that he can instantly decide on the manner of " treatment."

Most of it will be marked up as "Regular"—*i.e.*, to be treated on the general system of statements and coloured slips, or form letters, which have been devised for the ordinary routine of collecting. But there will be special cases, such as the fourth one shown in the summarised list, which will demand special thought and definitely individual treatment, in order to prevent that debt dragging on for months.



November 10th Debtor	Amount Due	Invoice Sent	Statement Sent	Treatment
Jones, Bristol	8. 2. 3.	Sept. 8th	Oct. 1	
Edwards, Nottingham	20. 18. 0.	10th	1	
Clark, Ipswich	6. 5. 9.	15th	1	
Williams, Sheffield	38. 2. 0.	July 24th	Sept. 1 Oct. 1	

Letter	Jan. Number Posted	Jan. Amount Recd.	Feb. Number Posted	Feb. Amount Recd.	March Number Posted	March Amount Recd.	Total 3 Months Number Posted	Total 3 Months Amount Recd.	Amount Collected per Letter
Plain Statement									
Statement and Coloured Slip 1									
Statement and Coloured Slip 2									
Letter 3									
Letter 4 & Regd. Reply Envelope									
Letter 5									
Solicitor's Letter 6									
Solicitor's Letter 7									
Special 10									
" 11									
" 12									
" 13									
" 14									
" 15									
" 16									
" 17									
" 18									

Form 1 is a summarised list of debtors supplied to the "chief" for his monthly survey. Form 2 provides a useful tabulation of results from collection letters.

Where necessary, the head will call for the ledger cards corresponding to the items on which he needs to refresh his memory.

The above is very simple, but by no means unnecessary. It is the first step towards a *systematised* treatment of debtors. It has first of all the effect of keeping the counting-house "up to the mark," in that their doings or not-doings in regard to debtors are placed in

the clear light of day instead of being hidden away in a mass of ledger pages or ledger cards; and, secondly, it is the initial step towards ensuring that slow debtors are followed up systematically, and that special kinds of debtors are marked out for individual and energetic pursuit.

The treatment having been decided upon, the next step is to make sure that it is carried out. The easiest system for this is to "tickle forward" the ledger cards of the debtors—either by noting them in a card index with guides marked with the days of the month, or else "signalling" the cards by distinguishing them with a coloured tab indicating the date on which the next collecting letter is to be sent out.

These letters are liable to be as tricky as sales letters in the results they actually achieve. And just as every progressive firm keeps a close analysis of the results obtained from circular selling letters, so do many firms with their collection letters, in order to get a line on effectiveness, and to revise and improve those which are not bringing in debts at a satisfactory rate.

Nor is it sufficient to test a set of form letters once and for all, and afterwards assume that they can go on indefinitely without alteration. Business conditions change. A time of slump is succeeded by a period of increasing prosperity; and a prosperous period gives way again to a condition of slump, or perhaps only a shallow but sustained depression.

And under different general conditions, business men are liable to change from one type of debtor to another. The man who is "honest but slack" during a period of prosperity, is quite likely, under the strain of severe losses, to become a "can't-pay-just-now," or "only as honest as he can afford to be." This not only means a

change of classes, but also, the *proportion of debtors in the various classes* must necessarily alter. With any such alteration, the effectiveness of any collection letter must vary.

In view of the above, it is clear that an important part of system in debt collection is to "tab up results" on collection letters from time to time. Form 2 on p. 115 provides a simple summary.

Another "system point" which requires careful attention is the interval between successive letters of a series.

In the set of general collection letters previously quoted for the case of a certain firm, the intervals were:

Statement and slip 1.
At 15 days—Statement and slip 2.
At 7 days—Letter 3.
At 7 days—Letter 4 and registered reply envelope.
At 7 days—Letter 5.
At 7 days—Solicitor's letter 6.
At 3 days—Solicitor's letter 7.

In other types of businesses, these intervals may be too short and liable to give occasion for offence. The letters are certainly too close together for a retail house doing a high-class trade amongst well-to-do credit customers; and far too close for a concern supplying municipalities and Government departments, who are accustomed to "hasten slowly."

When a firm does a "mixed trade" amongst customers of several different social or business classes, it may be advisable to segregate debtors by "time grades," and lengthen out the intervals between letters accordingly. Assuming that the collection letters were numbered 1 to 7, this system could be tabulated as shown on next page.

The time element arises in another form during the collapse of a boom period It is then vitally important to "tighten up collections."

Terms have to be shortened, and the usual intervals

WEEKS	GRADE A	GRADE B	GRADE C
1	1	1	1
2			
3			2
4	2	2	3
5			4
6		3	5
7			6
8	3	4	7
9			
10		5	
11		6	
12	4	7	

Follow-up periods of different classes of debtors need to be varied This chart forms a guide for one firm.

between letters cut down, in order to get money in quicker and avoid "slow debts" degenerating into "uncollectable debts"

In fact, it is advisable at such a time to revise the whole system; devise an entirely fresh set of letters applicable to the times and more insistent in tone; send them out at shorter intervals; and enlist the aid of sales manager and travellers in a combined "drive" to enforce "collections first."

CHAPTER XVII

"Tight Corner" Methods in Finance

EVERY business needs at some time or other to use devices for getting round a financial stringency. Usually it is a temporary emergency; sometimes it is a desperate case, "sink or swim." There are many methods which can be and have been used. None are infallible. All of them mean, in effect, getting somebody else to supply one with extra credit outside the customary credit channels. And the methods of doing so must necessarily vary with different types of business and circumstances.

Financing in-a-pinch is really a matter of realising on your property assets or on your credit assets in a way outside the regular financial pathways. But even at a pinch you cannot finance unless you have some property to sell, or unless you find some credit asset within yourself or your business which you have not used before. When money is needed for a business the first question therefore is "What am I to sell?" And the first answer is that the easiest and quickest source of funds lies in material property.

A young business man who needed money to tide him through a crisis found that his bank would take, as security for an additional overdraft a small mortgage on house property in a small town in the North—a mortgage that he had almost forgotten he possessed because it had been left him by his father at the latter's death,

and he himself had turned the income of it over to his wife.

Machinery and equipment have never been looked upon as a quick source of money, but the rise in the cost of machinery the last ten years has made it possible to sell second-hand machinery, through the auction room or through dealers, quickly at reasonable prices.

Many a business man who bemoans the lack of capital or has even been unable to come through a stringency, has failed because he did not realise what he had to sell. A firm which did a very large volume of advertising, involving much printed matter and many illustrations, was able to realise nearly £100 by the sale of old blocks and metal and out-of-date printed material. This certainly represented a loss on its accounts, but it was a dead loss eventually anyway, and the amount realised in cash was just that much found money.

Financing in emergencies is usually due to a slump in trade, and either the fact that for the time being trading is being done at a loss or too much money is tied up in fixed assets. Usually in a business of this kind it is one line or another that is showing profit, whereas some lines are showing a loss. Cutting off these losing lines will then not only decrease the aggregate loss, but may even allow money to be realised. Thus a musical instrument firm, which had committed itself to too great an extent in its purchases, was able to sell out its musical publishing department, including its copyrights of songs, its plates and so on, at a considerable figure. Many a business has thus been able to sell out the machinery and materials and stock, and even goodwill, representing a poor or temporarily loaning department, and so not only find ready cash, but also reduce expenses and cut losses.

Many businesses in urgent need of money have discovered that they had a saleable property in their leases. A small manufacturing business which had its machinery in the same building as its offices was able to move into a lower-class building at the same rent that it had been paying in the office building, and to sell its lease in the office building at a premium of £500.

Raising Money by Sub-letting Portions of Premises

A retail shopkeeper was compelled by competition to improve his shop front and his inside equipment. He did not have the money to do so, but he secured an advance for carrying out this work by sub-letting one floor of his building for an amount which in a little over a year would pay the cost of the improvement.

A wholesaler who had been operating in a district for many years used his leases in a slightly different way to increase his income. The street in which his building was situated had gradually become to be a fairly important thoroughfare, and small shops had encroached. He was able to so re-arrange his equipment that he could vacate the ground floor. It was an old-fashioned type of building, and in its then condition was not suitable for shops; and he did not have sufficient money to rebuild the floor. He got an estimate from a builder who specialised in this kind of work, together with an attractive drawing of the new shop front he proposed to put in and the plan of dividing the floor. With this drawing in hand he was in a few months able to secure tenants for six shops. On these signed leases he was able to borrow sufficient money to pay the builder for doing the work, and enough more to give him some liquid cash besides.

While the banks are usually ready to lend money on

mortgage on sound business property, yet it not infrequently happens that a property which looks very sound to the owner does not look that way to the bank. They may, on consideration, turn down the proposed loan as being a "doubtful case."

Now, some insurance companies also lend money on mortgage on business property. Usually, they decide their loans on much the same principles as a bank. But it sometimes happens that the would-be borrower has been able to offer to the insurance company an extra inducement which he could not offer to a bank. This extra inducement is the turning over of a group of business insurances, which he has already running with other companies, to the insurance company from which he asks the loan. In other words, he offers not only the security of his property and the annual interest on the loan, and the annual sum which he is prepared to pay into a sinking fund to extinguish the mortgage, but also a bunch of extra insurances business which that particular company does not already hold.

An old-established wholesaler, who had a regular fixed accommodation from his bank running into an overdraft of thousands, suddenly found that he needed further money in order to cope with a surplus stock. His bank would not extend his current overdraft, though they offered to take debentures on his entire business; but this was inadvisable, as it would have brought all his other creditors in on him. The wholesaler owned the freehold of the building he occupied. A business associate who knew this introduced him to an insurance company who loaned the necessary money on long terms secured by mortgage and sinking fund on the building only.

In many businesses, such as import and export

houses, the accepting of "bills" is a perfectly normal procedure and part of the regular routine of carrying on trading. But there are other types of businesses where a bill is an exceptional affair.

To illustrate, a small firm in the provinces owed a rather large sum of money to a London printing house for sales literature supplied. There was no question about the goods being delivered, found acceptable, and used. The only point was that the provincial firm were so hard pressed that they could not find the money to pay. The printers' account had run on for some months, and the printers were pressing hard for payment under threat of legal proceedings.

Using Bills to Obtain Further Credit

In this "tight corner," the provincial firm drew out a bill on themselves for the amount due, plus 6 per cent. interest for two months; filled in the date of payment as two months ahead; signed it as "Accepted"; had it stamped with the proper revenue stamp; and sent it to the printers, asking them to sign it as drawer and take it for security for payment in two months' time.

Of course the normal accepting of bills is by firms with an ample credit standing—and such bills are discounted every day by banks, because the names of the acceptor and the drawer are both considered as good security, and because the bank has recourse against the drawer to meet the bill if the firm who accept it do not pay up at the due date. In the above case, whether a bank would care to discount the bill or not, the whole risk lay on the shoulders of the printers. The transaction was, in effect, an asking for further credit on a promise to pay in two months with interest at 6 per cent. on the money. A bare request for this accommo-

dation would probably have been refused. But by putting it into the impressive form of an "accepted bill" with a proper revenue stamp, the provincial firm managed to scrape through.

An even more extreme use of "bill" is sometimes resorted to in cases of desperate emergency. This is the class of bill known to bankers as an "accommodation bill." The directors of Smith and Jones, Ltd., draw a bill on the company for (say) £1,000, accept it for the company, and endorse it personally as a further form of "guarantee." They then ask some business friend, Brown, to sign it as the drawer; to borrow money on it; and to pay over the proceeds of the borrowing to Smith and Jones, Ltd. If Brown tries to discount this at his bank, he will probably be told that the bank does not care to lend on it. The reason is that banks do not lend on "accommodation bills." But he may be able to borrow on it from a discount company or a money-lender.

Any business which has been frank and honest with its creditors can usually get an extension of credit on an open account by giving long-term bills, but even these bills eventually become due, and therefore these long-term bills are of no use unless the interval is used to secure ready money. A retailer found himself in this position and arranged with his creditors to pay by bills. Then he applied his selling ability to realising that amount of money in his business; he devised a good sales plan and cleared out as much of his stock as he could that way. Thereafter he made it a practice to remain in his shop for an hour each evening after closing time. In a rough way he went over his stock each evening noting what had been sold, what lines were either exhausted or so nearly exhausted that they would

not last another day, and he placed orders with wholesalers by wire or 'phone the following morning for only enough goods to carry him over forty-eight hours.

The result was that when his bills became due he not only had enough money to pay for them, but he found himself with a more compact saleable stock of goods at the end of the period with less dead stock on his shelves. Since then, he has more or less made this emergency scheme a regular policy of his business.

Another possible way of getting round "the tight corner" is to enlist the *voluntary support* of supply houses. Which means—placing the situation frankly before them, instead of hiding it, and asking for a sympathetic extension of credit on the security of one's personal integrity and general business ability.

A retailer hard pressed for cash went to his wholesalers and asked for goods on the basis of "Pay as I sell them." That is to say, he would place an order for such-and-such lines, on condition that he were permitted to pay for them as and when he sold them. And he also offered to give the supply house a lien on those goods until they were actually sold.

Goods "on Sale or Return"—a Custom in the Publishing Trade

A variation of the above is to ask for goods "on sale or return." This is a trade custom with wholesale newsagents and booksellers buying from publishers of journals and books. The publisher is made to carry the risk of their being sold at all to the public. It is an accepted custom with magazines and books—and in other trades it is sometimes granted, though it may be under pressure.

This applies more especially to stock standard articles

like baby carriages, sewing machines, and household furniture. They are not "seasonal goods," or likely to get out of fashion, or to deteriorate quickly. The manufacturer does not run a large risk in "lending" them to the retailer—and occasionally a man in an emergency can get some of his stock-in-trade in this fashion.

It is also possible to offer the security of a lien on the raw material when it is in the factory and before it is converted into finished products. In one such case the manufacturer, conducting operations on a large scale, offered to pay the expense of the supplier having a watchman on the premises to keep tally of the raw material, and notify the amount of stock-in-hand daily to the suppliers. This was accepted—but it was a case of an exceptional nature.

Pledging Trade-Marks and Goodwill as Security

Sometimes, again, the manufacturer's trade-marks and general goodwill can be pledged as security. Their value is always a matter of guesswork, but it may happen that they are favourably regarded by the man from whom accommodation is sought. He may possibly feel that if the business failed, he could himself take over the trade-marks and convert them into tangible value and profit.

Borrowing on work-in-progress is a legitimate form of borrowing. Builders and contractors frequently employ it.

Of course they cannot take the proposition to a bank, because a bank does not lend on the contingency of the successful carrying out of a contract. But suppliers of building material frequently do so—and the same applies to houses which supply component parts in engineering contracts. The security in such a case rests on three factors:

1. The credit standing of the firm who have given the contract—*i.e.*, their ability to pay for the completed article.
2. The ability of the contractor to make a success of the job he is handling.
3. The honesty and integrity of the contractor—*i.e.*, that he will pay for the supplies when he has himself received the money from the firm who are giving out the contract.

And it follows that all these three factors must be "good" before the supply house will lend their goods in such a manner.

Accounts receivable are not ordinarily good security for an advance of money, because to make such an arrangement legally binding every debtor must be notified that the account has been mortgaged, so to speak; but they can be used as a proof of assets. The proprietor of a certain business was able to obtain a considerable advance of spot cash by presenting a statement that showed three sets of facts: First, all his accounts receivable were listed by name, and under each name was shown the amount of business that had been done with this debtor the last three years, and the average time it took to pay each item of indebtedness; secondly, he showed his own accounts payable, which aggregated a total far under that of his accounts receivable; thirdly, he showed the amount of raw material in working process he had in his factory, what it was worth at cost price, and what it would be worth when sold; and he listed the volume of unfilled orders he had in hand with the name of each buyer. With this information in hand, he was able to guarantee that out of the list of old accounts receivable he would be able

to set aside half the amount collected in every case to pay for the advance, and yet not get himself into further difficulties. This was not a strict legal protection for the borrower, but it was a moral protection, and it proved an adequate safeguard.

Paying in Full after Pressure does not Remove Doubt of Solvency

In a "tight corner," one has to pay out what is possible to one's creditors in a way which will best serve one's solvency. And this means paying nobody in full. If a man has reason to doubt your solvency, presses hard for payment in full, and gets it, he will probably give orders to his counting-house to trust you with nothing further until the skies are perfectly clear. The payment in full will not dispel his justifiable doubts, but only serve as a matter of self-commendation in pressing so hard for settlement and getting it. It will not secure further credit during the period of difficulty.

In such a situation, many a business has had to distribute the risk over a number of shoulders, so as to have as many people as possible directly interested in the maintaining of its solvency and the possibility of eventually getting paid in full. It pays something "on account" to all the creditors, and lets them know delicately that no one of them is getting a big advantage over the others. It keeps them all "in the boat."

CHAPTER XVIII

The "Money Market" as a Business Barometer

TO many people "The Money Market" is something strange, foreign, and outside the region of everyday practical business.

But those business men who watch it, keeping an eye on it once a week or so, are often able to make deductions which profitably affect the working policy of their own business.

Perhaps it is not too obvious to mention that "The Money Market" means the general meeting-ground of big financial interests—Governments, banks, discount companies, bill brokers, insurance companies, and large mercantile concerns who, on the one hand, have surplus money to loan out temporarily, or, on the other hand, want to borrow money for a short period. In this pond where the big fish swim, "loanable money" becomes a commodity with a price on it, the price being expressed as "rate of interest" or "rate of discount." And the price naturally varies according to supply and demand, just as with any other commodity.

When the demand is strong, the price rises. When the supply is strong, the price falls.

The mercantile demand is strong when trade is brisk and all sorts of firms are "spreading out their sails." The mercantile demand is weak when trade is slack and all kinds of firms are "hiding in their burrows."

The governmental demand is strong when the

Treasury is needing temporary money to cover a big seasonal pay-out, such as dividends on Government stock. The governmental demand is weak when money is coming rapidly into the Treasury, as at the seasonal times when the income-tax collectors are hard on the heels of their victims.

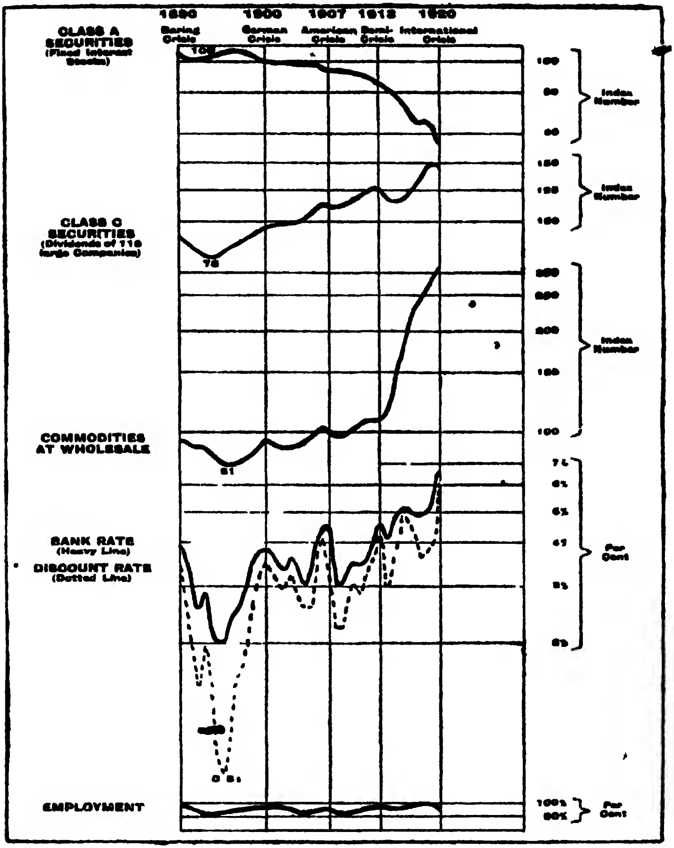
The supply of "loanable money" comes chiefly from the banks—out of the surplus money in their hands arising from the deposits of their customers.

This bank source of supply is strong at a time when people are not spending, either in business or in private life, and are not adventuring their money either in business enterprises or in speculation. The bank supply is liable to be weak when people are spending easily and adventuring freely.

All the above causes produce an effect which is best explained by taking the two extremes of the height of a boom and the depth of a slump.

At the height of a boom in business, "loanable money" becomes very scarce, and its price rises high. At the time of a severe slump, "loanable money" becomes plentiful and its price drops very low.

If you will glance at the chart accompanying this chapter, you will see that in the slump years of 1893 to 1895, the *bank rate* went down to 2 per cent., and the *market rate of discount* to as low as 0·8 per cent. The curve of *employment* shows that business was then very "dead," because nearly 10 per cent. of workers in the United Kingdom were workless. The curve of *commodities at wholesale*, also dipping heavily, is another clear sign of "bad business." And, further, the curve of *dividends paid by* 118 *large industrial companies*, falling in the same way, proves that "times were very hard."



This section is extracted (by permission) from "Trade Cycles Chart," compiled by Joseph Kitchin, covering 140 years. The 1890 to 1920 period is taken as being most nearly related to recent business conditions. It will be seen that the fluctuations of the bank rate and discount rate are followed, in general, by the curves of percentage of employment, price of commodities at wholesale, and dividends declared by large industrial companies' "Class C" securities. On the other hand, the value of fixed interest stocks ("Class A" securities) moves in the reverse direction. The reasons are explained in this chapter. (The curves are drawn on "logarithmic scale")

If we then consider the period from 1895 to 1900, we find in the chart that all five curves moved upwards, until in 1900 the bank rate was 4 per cent.; the discount rate just under that figure; employment was nearly 100 per cent.; commodities had increased in price from an index figure of 81 to 100; and company dividends had moved up from an index figure of 78 to 100.

In 1900 another "financial crisis" came along. It is well known that they are due at the end of every "trade cycle"—and a "trade cycle" runs from seven to ten years. But this crisis of 1900 was not so severe. British industry weathered it better. The downward dips are not nearly so pronounced. In due course the slump came to an end, and all five curves moved upwards till the next crisis of 1907. And so on.

It is clear from the chart that these five curves move, broadly speaking, in the same direction—either upwards or downwards. *And therefore it is reasonable to assume that they all moved by the same economic cause.*

In fact, the bank rate and discount rate are the outside and visible signs of the health or illness of the general industrial body—and that is why they form such a valuable business barometer.

Drawing Business Deductions from Bank Rate and Discount Rate

From the above it follows that a quick and continued rise in the price of "loanable money" during a boom time means that a financial crisis is in sight. It is a warning to the prudent business man to reef in his sails and prepare for stormy weather.

For instance, in October and November of 1919, the Federal Reserve Bank of New York raised its rate in rapid succession to 10 per cent., 15 per cent., 20 per

cent., and 25 per cent.—a red light signal of the most obvious character—but the great majority of speculators in stocks and shares and speculators in commodities ignored its warning. The inevitable consequence was a tremendous slump on the New York Stock Exchange, and also a huge slump in the value of commodities. Only a few people heeded the "red light." These men made money.

In Great Britain, the same thing came nearly a year later, but not with such striking vehemence. A very high money rate was the forerunner of slump both in stocks and shares and in commodities; but few people took heed of the warning and "liquidated their commitments" in time to avoid big losses.

Again, when discount rates sink to as low as 2 per cent. or perhaps lower, and then begin to rise steadily, this is a financial symptom which has been followed in the past by a period of increasing business confidence and briskening trade.

The discount rate is a more sensitive barometer than the bank rate. This is clearly shown in the chart, where its swings are markedly more pronounced.

How Prices of Securities are Affected by Bank Rate and Discount Rate

Every business man is interested in the prices of some stocks and shares, either through personal holdings or holdings on the part of his firm. And these prices are directly affected by the "ruling rates for money." But the subject is made complex by the fact that *different kinds of securities are affected in different ways*. The reasons for this are important to every business man, and ought to be more widely known than they are.

Speaking in broad terms, one can divide up securities into three main classes:

Class A.—"Gilt-Edged Securities"—i.e., those in which a trustee is allowed to invest, such as Government loans, municipal loans, and debentures and preference shares of the big railway companies. Also prior-lien shares of banks, insurance companies, public utilities, and other concerns of outstanding stability.

Class B.—Medium Grade Securities—i.e., preference shares of industrial and other companies, which carry a higher rate of interest than gilt-edged securities, but involve a greater degree of risk.

Class C.—Speculative Investments—i.e., ordinary shares of industrial companies, mining shares, and so forth.

When money rates go down, securities of Class A go up. This is shown very clearly in the chart, where the curve of Class A securities moves in the reverse direction to the other five curves.

The reason is simple if one thinks of one's own money placed "on deposit" at a bank. When the bank rate is 6 per cent., the bank pays one 5 per cent. interest. This is quite nice, and so one leaves the money on deposit. When the bank rate falls to 5 per cent., the bank pays 4 per cent. interest, and it is not quite so happy a state of affairs. When the bank rate falls to 4 per cent., and the bank pay one only 2 per cent. interest, one begins to feel that this return is too low, and that it would be advisable to take out the money and buy some gilt-edged securities paying 4½ per cent. or 5 per cent.

This feeling is a perfectly natural one, and is shared by hundreds of thousands of people. Impelled by the same motive of self-interest, a very large number withdraw their money from the bank and invest it in sound securities offering them a higher rate of interest. And the logical consequence is that the prices of these gilt-edged securities rise.

The bigger the fall in money rates, the bigger the demand for securities of Class A, and therefore the higher the market price. This was very clearly shown in the first six months of 1922.

On the other hand, when rates begin to climb, the prices of gilt-edged securities begin to fall. People reckon out that they could get just as good a rate of interest, or better, by transferring their savings from gilt-edged securities to money on deposit with a bank. And, impelled by self-interest, they do so.

Therefore the price of Class A securities recedes with the increase in price of "loanable money."

Class C securities move in an opposite direction.

When money rates go down, it means that business is slack and profits are restricted. Therefore the value of ordinary shares in an industrial company becomes less, and the market price of these shares falls.

On the other hand, when money rates are reviving, it means that business is becoming brisk and that profits of industrial companies are likely to be increasing. Therefore the price of ordinary shares in such companies goes up.

Class B securities may "move in both directions." That is to say, they may follow the lead of Class A for a time, and then lag behind; or they may follow Class C for a while, and then fall behind. At a time when everybody is seeking "safety," they cannot be as

popular as gilt-edged securities; and at a time when most people are looking for a high rate of interest, they cannot be as popular as ordinary shares. Their high and low points are therefore likely to come in between the high and low points of Class A and Class C.

It should be clear from the above that since these three classes of shares move in such different ways, it must inevitably produce a great *complexity of movement* in the mass of quotations for stocks and shares of all kinds. And that is perhaps the reason why so many people regard the prices of securities as being outside the laws of logic—and their movements a matter of sheer guesswork on the part of the "outsider."

But in reality they are directly governed by the money rate. This rate is the focus of the big financial currents. It is the essence of the financial thought of a whole nation—in fact, in the case of the London rate, it is the essence of the financial thought of Great Britain, Europe and America combined.

It represents the concentrated psychology of hundreds of millions of people.

Handling Reserves and Investments

The principles set out above, which are founded on the movements of money rates and securities for the last hundred years, offer a broad guidance to any business man, not only in the handling of the reserves and investments of his firm (which subject is treated in the next chapter), but also in determining the future course of trade and planning for either prosperity or retrenchment.

CHAPTER XIX

How to Deal with Reserves and Investments

By CECIL CHISHOLM,
Managing Editor of "Business."

IN every phase of life, the best insurance, the surest safeguard against sudden emergencies, is reserves. It is a maxim in military life—it is true in one's own health—and it is just as true in business.

Many a profit-making business has failed, firms sound in their trading have stumbled in an emergency, merely because they did not take the precaution to build up a reserve of some kind. Two kinds of business men find it difficult to build up a reserve: those who are running along upon a very low margin of profit and who are therefore not in a position to take any money out of the business; and those who are so eager to expand that they devote all their profits to expanding their businesses.

The more complicated the structure of business as a whole grows, the more necessary are reserves. There may be a disastrous strike, a costly legal action, a large trading loss; a mine may be flooded, a factory wrecked by fire; a quick change in public taste or slump in trade, a sudden dangerous competition—all these emergencies call for throwing in of reserves.

The first question to determine is how to accumulate reserves; the second, in what form to keep the reserve funds; the third, what use to make of them.

Reserves come out of profits. But it is a mistake to think that any profits not paid out in dividends necessarily become a sound reserve. In a practical sense, one may define reserves as moneys or assets, over and above the usual capital requirements of a concern, sufficiently liquid to be realised on at will without interfering with the processes of the business or crippling its operations.

Investments in Plant, etc., are not Practical Reserves

If a business has an original capital of £20,000, invested half in building and machinery and fixtures, one-quarter in accounts receivable, and one-quarter in stock in hand and bank balance; and such a business out of its profits over a period invests another £5,000 in machinery, £2,500 in accounts receivable, and £2,500 in increased stocks in hand—it is not building up a reserve in the practical sense of the word even though it may appear as a reserve on the books of account.

The practical way for a business man to look at it is this: a part of profit shall be paid out in the form of dividends in a company, or partners' drawings in a firm; a portion of the profits shall be left in the business to allow expansion; and a final portion of the profits shall go to the accumulation of a real reserve.

A wholesaler, who started forty years ago with only a few pounds, and has built up a considerable personal fortune and a business with an investment of over half a million, has made it a principle in every company with which he is connected to distribute annual profits as follows: the first £1,000 always to go into reserves, actually drawn out and invested in a deposit account or in realisable securities; at least one-half of the remaining profits to remain in the business for expansion,

and in good years a percentage of this also to be devoted to the reserve fund. To a big company £1,000 a year may not sound a large amount to add to reserve, but in the course of nearly half a century it has meant a very substantial accumulation.

A publishing business probably suffers from ups and downs as much as any business; one publisher has made it a policy to invest a certain fixed percentage of each year's profits in conservative securities, no matter what the temptation might be to use the money otherwise. Another firm has built up its reserve by fixing a certain minimum dividend which is first paid, and then devoting a certain percentage of the surplus profits to a reserve invested in securities; this means that in prosperous years a large amount is added to reserves whereas in poor years it may not be increased at all.

An overseas business devised a novel plan for building up reserves. It is a comparatively new business, and all the directors and officials of the business are shareholders in it. They receive salaries for the active work they do, in proportion to the importance and value of their work, and these salaries are paid monthly. On each pay-day 20 per cent. of the salary of each of these officials and directors is paid into an independent investment trust company, organised by the parent company at a small nominal capital and owned by the parent company; in return for their payments the officials receive merely a certificate of their deposit. As soon as the investment company has £200 accumulated, it buys a first-class security. The earnings from these securities are not paid out, but are merely credited proportionately to the various depositors and then reinvested. It is a fixed part of the articles of agreement of this investing company that money can be withdrawn

from the company only if a depositor leaves his position in the parent company (in which case he receives his original deposits and accumulated interest), or if the parent company needs the money in time of emergency because it cannot be obtained elsewhere. The holdings of this investment company now total nearly £20,000, and it is interesting to note that no money has ever actually been paid over to the parent company, but the securities of the investment company have at times been used by the parent company as collateral for raising loans for emergency needs.

As may be seen from the reports of annual meetings, big public companies build up their reserves by establishing various accounts—depreciation account, reserve for future dividends, reserve for bad debts, reserve for depreciation of securities, general reserve, carry forward, etc. These are not all available reserves, as some of them may be drawn on only for the purpose for which they are established; nor does it necessarily signify that these reserve accounts are quickly realisable—they may be remaining in the business in the form of fixed investment and therefore more or less unrealisable.

The building up of a variety of reserves can be applied in any business, however small. It is really a method by which the accounts of a firm are so kept as to hold down the apparent profits and therefore minimise the temptation to pay them out in dividends. Reserves may be established for all kinds of contingencies, not only for depreciation and bad debts, but for certain more problematical contingencies—such as, for instance, possible leasehold dilapidations, loss on exchange, depreciation of goodwill or copyrights, bonuses to staff, etc. It may again be emphasised, however, that the mere crediting of certain moneys to such accounts does

not necessarily mean that these reserves are in liquid and realisable form. As a rule it means that this money is remaining in the business, is being used not to swell the bank balance, but to allow the carrying of more accounts receivable or increasing the investment in plant and stock.

The reason a policy of investing a certain fixed sum or percentage out of profits each year in outside reserves is so sound, is because the temptation upon a business man constantly is to pay out nearly all his profits in dividends in poor years, and in good years to invest a large percentage of the profits in the business in fixed form—with the result that in the end he builds up no liquid reserves at all.

Reserves Should be Used to the Best Advantage

But having built up his reserves, the aggressive business man will want to make the most of it. In other words, idle funds are always a waste in business, and a reserve can be made doubly valuable in a business if, as well as being a safeguard and insurance, it can also be made productive and a source of profit. The head of a large distributing house came back from an extended absence to find those he had left in control jubilating over the large bank balance they had in hand and the extension of their liquid funds. He soon pricked their bubble with the remark: "We employ expert managers in our business to use our money at a 10 per cent. profit in the business rather than to lock it up in a bank at 2½ per cent. Let us put this money back into the business and let it earn that additional 7½ per cent., which it can."

A well-known accountant has laid down a rule that the object of a reserve may be divided into two heads

First, a reserve may be built up to meet a periodical or seasonal demand, as where the forecasting of receipts and disbursements indicates that obligations may profitably be taken up with surplus funds in certain months of the year, while heavy receipts in other months of the year will again build up the reserves for future needs.

Second, a reserve may be laid by blindly as insurance against emergency needs or a financial crisis.

Third, reserves may be accumulated as a "war chest" with which to carry on certain unusual operations that the business has in view, or to meet a condition when supply or demand or competition is going to offer an unusual opportunity.

Consequently the statement that a reserve which is simply re-invested in the ordinary conduct of a business is not liquid and dependable, must not be stressed too far. For many concerns, especially those dealing in staple raw materials or easily marketable commodities, can look upon their raw materials and stocks as being so quickly realisable as to form liquid reserves. With such firms it is legitimate to re-invest their surplus in the ordinary operations of the business Reserves are also at times used to make a large purchase at a very favourable price either for holding or for re-sale. Some retail organisations keep a large cash reserve in order that they may be in a position to buy special lines of goods, liquidators' stocks, bankrupt stocks, etc., quickly and at very favourable prices.

A reserve may be accumulated not as a permanency but for definitely anticipated expenditure, especially when a business has periodical or seasonal demands. If a factory, for instance, makes stock goods at a certain season of the year and accumulates them, and has only

a short selling season of a few months in the year, then it will be short of money towards the end of its heavy producing season and the beginning of its heavy selling season when all the money is going out in purchases; and it will have a surplus of money during the latter half of the selling season and the first part of the producing season when the moneys for goods sold are coming in. In this case, it is usual in such a business to accumulate sums, to an amount based on past experience, during the season of heavy income, and put them as deposit accounts in the bank or into short-term securities, and then draw on them again in the dull season.

Reserves to be Kept in Form Decided by Character of Business

In deciding upon the form in which to keep his reserves, therefore, the business man must be guided by the character and need of his business. As to amount, some businesses of a speculative character or with a highly seasonal turnover, will require a far larger proportion of reserves than a steady, uniform and evenly flowing business in a staple line. As to the form of reserves, a business operating in commodities of a staple character with an open and steady market, need carry far less of its reserves in cash and far more in its own operations than can a speciality business or one in which other factors in the business are of more importance and absorb more capital than do the materials dealt in.

But this may be said positively: that if a reserve is invested *outside* of a business, it should be invested in conservative securities, non-speculative, not subject to great variations in market prices or interest yield, not requiring a constant knowledge of the business involved,

easily realisable and recognised as good collateral. No wise business man, for instance, would invest the surplus of his business in land, or in the ordinary shares of an outside private company whose securities were not saleable in the open market.

Four general tests for such an investment may be laid down:

1. Are your principal and interest safe or certain to come in when due?
2. Is the net return or rate of income on the investment advantageous?
3. How does the security rank as to ease of converting it into cash, and how staple is its market value in time of crisis?
4. What are the prospects of the security increasing in value?

Reserves Form Sheet Anchor of Business in Times of Stress

Safety is the prime consideration in a firm's investments. The reserves of a business form its sheet-anchor in stormy weather. No lure of possibly large profits should divert reserves into speculative enterprises; safety comes first. Then as high a yield as is consistent with safety. This is what the prudent business man seeks.

And he will find them—over the whole period of a "trade cycle," including boom and slump—by putting the reserve money into: (1) Trustee stocks; (2) deposits at interest with a bank; and being prepared to switch the money backwards and forwards from time to time according to the general indications of the market rate for money, as discussed in the previous chapter.

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